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Planning for Estates Under the $10 Million Exemption

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TABLE OF CONTENTS

TABLE OF CONTENTS 1
Introduction 1
1. Legislative Developments 1
2. Treasury-IRS Priority Guidance Plan; "BDITs" 7
3. General Approaches to Estate Planning Following ATRA; The "New Normal" 9
4. Planning for Couples Having Under $10 Million 11
5. Portability 23
6. Estate and Income Tax Intersection—Basis Planning for Larger Estates 37
7. Basis Adjustment Flexibility Planning 42
8. Planning Basis Adjustment Regardless Which Spouse Dies First; Joint Spousal Trusts (To Facilitate Funding Credit Shelter Trusts and for Basis Adjustment); Section 2038 Marital Trust 54
9. Trust and Estate Planning Considerations for 3.8% Tax on Net Investment Income and Income Taxation of Trusts 58
10. Gift Planning Issues for 2014 and Beyond 87
11. Resurrection of "De Facto Trustee" Concept--*Securities Exchange Commission v. Wyly* 90
12. Defined Value Clause Updates 99
13. Sale to Grantor Trust Transaction (Including Note with Defined Value Feature) Under Attack, *Estate of Donald Woelbing v. Commissioner* and *Estate of Marion Woelbing v. Commissioner* 102
14. Same-Sex Marriage Issues 106
15. Charitable Planning Reminders, Strategies and Creative Ideas 113
16. Residence and Domicile Issues—State Income Tax Issues 119
17. Inherited IRAs Not Protected in Bankruptcy, *Clark v. Rameker* 121
APPENDIX A 123
APPENDIX B 125

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INTRODUCTION

This discussion of practical planning strategies for $10 million and under estates includes observations from the 48th Annual Philip E. Heckerling Institute on Estate Planning as well as other current developments.

1. LEGISLATIVE DEVELOPMENTS

a. ***Overview of Administration's Fiscal Year 2015 Revenue Proposals.*** The Treasury on March 4, 2014 released the General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals (often referred to as the "Greenbook") to provide the details of the administration's budget proposals. For a discussion of the proposals impacting estate planning in the 2014 Fiscal Revenue Proposals, see Item 2 of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.Bessemer.com/Advisor. A few summary comments about particular proposals in the Greenbook are included below.

b. ***Transfer Tax Legislation Unlikely in 2014.*** The various transfer tax proposals will likely proceed only as part of a general tax reform package, and not as a package of separate transfer tax legislation. There have been some indications, however, that transfer taxes are not being considered in the reform measures.

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

   The likelihood of transfer tax legislation (which itself is always politically charged) this year is almost nil. Inclusion of some of the specific transfer tax measures that would raise some revenue is always possible, however, as an add-on to other legislation that needs revenue offsets to help pay for the legislation.

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

   - *Restore 2009 estate, gift and GST Tax parameters, beginning in 2018.* This proposal is not taken seriously. (Estimated 10-year revenue: $118.282 billion.)
   - *Require consistency of basis for transfer and income tax purposes.* This proposal has generally been well received. However, Carol Harrington observes that this provision is unfair because the beneficiary may have had no input in the estate tax

audit negotiations, and the executor may have "traded off" on the valuation of various assets. With this provision, the executor will have to consider the effect of audit negotiations on the basis of assets received by the various individual beneficiaries. (Estimated ten-year revenue:$2.501 billion, up from $1.896 billion that was estimated in the 2014 Fiscal Year plan and from $2.014 billion that was estimated in the 2013 Fiscal Year plan.)

- *New GRAT requirements.* Requirements include (i) a 10-year minimum term, (ii) a maximum term of life expectancy plus 10 years, (iii) a remainder value greater than zero, and (iv) no decrease in the annuity amount in any year. Several years ago, this was included in various bills that needed revenue offset, but it has not been included in any bills over the last year. The proposal applies to GRATs created after date of enactment; it is extremely unlikely that this will be retroactive to the beginning of the year (as was done—probably inadvertently as to this provision—in the "Trade Adjustment Assistance Extension Act of 2011" legislative proposal). (Estimated ten-year revenue: $5.711 billion, up from $3.894 billion in the 2014 Fiscal Year plan and $3.334 billion in 2013 Fiscal Year plan.)
- *Limit duration of GST exemption to 90 years.* This proposal has not generated a groundswell of criticism. The proposal would apply to trusts created after the date of enactment and to the portion of preexisting trusts attributable to additions after that date (subject to rules substantially similar to the grandfather rules). (Estimated ten-year revenue impact: Negligible.)
- *Sales to grantor trusts.* This proposal has been substantially narrowed from the proposal in the 2013 Fiscal Year Plan to include all grantor trusts in the settlor's gross estate. Nevertheless, it is still a huge change and passage seems unlikely. The proposal applies to trusts that engage in a "sale, exchange or similar transaction" on or after the date of enactment. Carol Harrington's observation: "The government created the grantor trust rules and did not coordinate them with the wealth transfer tax… Now they are shocked and appalled to find that we have used the law to our advantage. The government's answer is to layer an even more complex system on top of the transfer tax."

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

  Estimated ten-year revenue: $1.644 billion, up from $1.087 billion in the 2014 Fiscal Year plan; interestingly this is less than the consistency of basis provision [$2.501 billion] and the GRAT provision [$5.711 billion].)
- *Section 6166 estate lax lien.* The special estate tax lien under §6324(a)(1) would last for the full period that estate tax is deferred under §6166 rather than being limited to just 10 years after the date of death. (Estimated ten-year revenue: $213 million, up from $160 million in the 2014 Fiscal Year plan.) This almost certainly will be included in any transfer tax legislation that passes.

- *Health and Education Exclusion Trusts.* "HEET" trusts are a seldom used strategy to create a long term trust out of which tuition and medical payments could be made for future generations without any GST tax. Unfortunately, the proposal is Draconian in approach. It would eliminate the current exclusion under §2503(e) for payments from a trust for the health or tuition payments for second generation (and more remote) beneficiaries. Furthermore, the proposal has a seldom used—very harsh effective date provision—applying to trusts created after and transfers after the date of the introduction of this bill. Carol Harrington's reaction (joking): "HEETS are not great anyway…But based on this proposal, I may have to rethink this. They must be a lot better than I thought." (Estimated ten-year revenue: *Negative* $218 million)
- *Simplify Gift Tax Exclusion for Annual Gifts .* Referencing the complexity of administering *Crummey* trusts and the potential abuse of having multiple beneficiaries with withdrawal powers "most of whom would never receive a distribution from the trust," the administration proposes deleting the present interest requirement for annual exclusion gifts, allowing $14,000 per donee exclusion for most outright transfers, and adding a new category of gifts to which a $50,000 *per donor* annual limit would apply. The proposal applies to gifts made after the year of enactment.

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

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

  The reference to "transfers of interests in passthrough entities probably relates to the complexities of whether interests in partnerships or LLC constitute present interests (which the IRS has had success in attacking, as reflected in the *Hackl*, *Price*, and *Fisher* cases).

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

  - Gifts paid directly for tuition or medical expenses, §2503(e);
  - Gifts of $14,000 per year (in 2014, indexed amount) (but not including gifts to trusts [other than "vested" trusts, as discussed immediately below], passthrough entity interest gifts, transfers subject to sale prohibitions, and transfers that cannot immediately be liquidated by the donee) for (i) outright

gifts (other than gifts to trusts other than "vested" trusts, passthrough entity interest gifts, transfers subject to sale prohibitions, and transfers that cannot immediately be liquidated by the donee) and (ii) gifts to "vested" trusts (described in §2642(c)(2), which has the effect of allowing a trust similar to §2503(c) trusts but without the requirement of terminating at age 21); and

- Gifts of up to $50,000 annually in the aggregate (regardless how many donees enjoy such gifts) for (i) trust transfers (other than transfers to "vested" trusts, for which the $14,000 per done exclusion would apply), (ii) passthrough entity interest gifts, (iii) transfers subject to sale prohibitions, and (iv) transfers that cannot immediately be liquidated by the donee.

(Estimated ten-year revenue: $2.924 billion)

- *Expand Applicability of Definition of Executor*. The definition of "executor" in the Internal Revenue Code applies only for purposes of the estate tax. There is no one with explicit authority to act on behalf of the decedent with regard to a tax liability that arose prior to the decedent's death. This includes actions such as extending the statute of limitations, claim a refund, agreeing to a compromise or assessment, or pursing judicial relief regarding a tax liability. The proposal would make the Code's definition of "executor" applicable for all tax purposes "and authorize such executor to do anything on behalf of the decedent in connection with the decedent's pre-death tax liabilities or obligations that the decedent could have done if still living.. Regulations could provides ruls to resolve conflicts among multiple executors. The proposal would be effective upon enactment, regardless of a decedent's date of death. (Estimate ten-year revenue: Zero)
- *Omission of Section 2704 proposal.* In prior years the Obama administration has proposed revising §2704 to add an additional category of applicable restrictions (to be provided in regulations) that would be disregarded in valuing transferred assets. That proposal was dropped in the 2013 Fiscal Year plan. (This prior proposal had an estimated 10-year revenue impact of $18.079 billion in 2013 Fiscal Year plan, which is significantly more than all the estate and gift tax proposals combined in the 2014 Fiscal Year Plan other than the proposal to return rates and exemptions to the 2009 parameters. The Congressional Budget Office and Joint Committee on Taxation refused to score this proposal because it depends entirely on positions taken in regulations, and the IRS cannot consult with them about its thinking on provisions that might be in proposed regulations.) While the IRS has previously worked on a §2704 regulation project "regarding restrictions on the liquidation of an interest in certain corporations and partnerships," this does not appear to be a Treasury priority.
- *Reporting requirement for sale of life insurance policies and eliminate transfer for value exceptions.* Hopefully, the legislation would be limited to purchases of policies by third-party investors as opposed to transfers of policies among the policy owner and related persons, trusts or entities.

- *Payment to non-spouse beneficiaries of inherited IRAs and retirement plans over five years.* The 2014 Fiscal Year Plan added a new proposal requiring that non-spouse beneficiaries of inherited retirement plans and IRAs generally must take distributions over no more than five years. Exceptions are provided for disabled beneficiaries, chronically ill beneficiaries, individuals not more than 10 years younger than the participant, and minor beneficiaries. The 2014 Fiscal Year plan did *not* specifically make this requirement applicable to Roth IRAs. The 2015 Fiscal Year plan provides that all of the minimum distribution rules would apply to Roth IRAs the same as other IRAs (applicable for taxpayers reaching age 70 ½ after 2014). Therefore, Roth IRAs would be subject to the 5-year distribution requirement. The proposal would be effective for plan participants or IRA owners dying after 2014, the proposal appears to apply to Roth IRAs only if the owner reached age 70 ½ after 2014 and died after 2014. This proposal, while a dramatic change, has significant acceptance on a policy basis (of requiring that retirement plans be used for retirement). (Estimated 10-year revenue: $5.159 billion)

  The five-year distribution requirement provision was included in the Chairman's Mark of the "Preserving America's Transit and Highways Act of 2014" (June 24, 2014). However, the House passed a measure to extend the funding of the Highway Trust Fund through May 2015, and the 5-year distribution provision not included in that extension. (This is the "Transportation Bill" that has been languishing in Congress for several years to provide funding to maintain numerous transportation projects and the nation's highway system.)

- *Limit total accrual of tax favored retirement benefits.* This proposal, also added in the 2014 Fiscal Year Plan, generally would limit the deduction for contributions to retirement plans or IRAs with total balances under all such plans that are sufficient to provide an annual benefit of an indexed amount, representing plan amounts of about $3.2 million for a 62-year old individual in 2014. Commentators have observed that this provision can be complex to administer because individuals would have to disclose the value of all of their retirement plans to employers, who would then have to monitor the value of all such plans. (Estimated 10-year revenue: $9.342 billion)

- *Eliminate MRD requirements for qualified plans and IRAs under aggregate amount of $100,000 (indexed).* The minimum distribution rules would not apply if the aggregate value of the individual's IRA and qualified plan accumulations does not exceed $100,000 (indexed for inflation). The proposal applies to individuals reaching age 70 ½ after 2014 or who die after 2014 before attaining age 70 ½.

- *60-Day Rollover for Inherited Retirement Benefits*. Surviving spouses may received benefits from an IRA outright and roll them over to another IRA (a "60-day rollover"), but beneficiaries other than spouses may only make a trustee-to-trustee transfer from the decedent's IRA to an inherited IRA. The 2015 Fiscal Year plan for the first time acknowledges that the trustee-to-trustee transfer

requirement “creates traps for the unwary” for non-spouse beneficiaries, and allows non-spouse beneficiaries to make 60-day rollovers to another IRA. The proposal applies to distributions after 2014. (Estimated 10-year revenue: Zero)

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

d. ***Charitable Provisions in H.R. 4719, The America Gives More Act.*** The House approved H.R. 4719, “The America Gives More Act,” on July 17, 2014. It includes several provisions to increase charitable giving. These include:

- a retroactive and permanent extension of the “IRA charitable rollover” (which allows individuals age 70 ½ or older to donate up to $100,000 annually to charity directly from their IRAs without having to treat the distributions as taxable income);
- allowing charitable contributions through April 15 to be deducted on the prior year return;
- revising the current 1 or 2 percent excise tax on investment income of private foundations to a single rate system of 1 percent;
- providing enhanced deductions for conservation easements; and
- providing enhanced deductions for food inventory.

The Senate will probably not consider this provision as drafted but more likely will, sometime in the fall or after the mid-term elections, propose a two-year retroactive extension of the IRA charitable rollover for 2014 and 2015.

e. ***Tax Extenders Extended Just Through End of 2014***. H.R. 5771 was passed by the House on December 3, 2014 and by the Senate on December 16, 2014, and signed by the President on December 19, 2014. Division A of H.R. 5771 is the “Tax Increase Prevention Act of 2014.” It extends various items through December 31, 2014, retroactive to January 1, 2014. There were negotiations to pass a two-year extender package (through December 31, 2015), but the President indicated that he would likely veto the two-year extension package (on the basis that it provided more benefits to businesses than individuals), so the two-year extender package was not adopted. Accordingly, the extended provisions were just extended them through the end of December 31 (or 13 days from the day they were enacted). Among other things, the Tax Increase Prevention Act of 2014 includes extensions of the following items from January 1, 2014 through December 31, 2014:

- extension of the "IRA charitable rollover" (which allows individuals age 70 ½ or older to donate up to $100,000 annually to charity directly from their IRAs without having to treat the distributions as taxable income);
- election to claim itemized deduction for state/local sales taxes in lieu of state and local income taxes;
- exclusion of home mortgage forgiveness from discharge of indebtedness income for the discharge (in whole or in part) of "qualified principal residence indebtedness" for a "principal residence";
- deductions of contributions of real property interests for conservation purposes are allowed subject to a 50% of the taxpayer's contribution base limitation (100% for qualified farmers and ranchers) and a 15-year carryover;
- accelerated depreciation of certain business property (bonus depreciation);
- shortened S corporation built-in gains holding period (5 years rather than 10 years);
- for charitable contributions of property by S corporations, the shareholder's basis is reduced only by the contributed property's basis; and
- 100% exclusion from gross income of gain from the sale of qualified small business stock.

f. ***ABLE Accounts***. The Achieving a Better Life Experience Act of 2014 (the "ABLE Act") created new Code section 529A. If allows the creation of accounts somewhat like 529 Plans for individuals with disabilities. States are authorized to create qualified ABLE programs for individuals who would qualify for SSI or OASDO benefits. Only a single account could be created for any individual, and contributions to the account are limited in the aggregate to $14,000. IT can grow tax free (like a 529 Plan). IF distributions are used to pay qualified disability expenses, they are not included in gross income. There is a liberal definition of qualified disability expenses, covering many expenses that Medicaid does not already cover. If a distribution is made that is not a qualified distribution, it is subject to a 10% penalty in addition to being included in gross income.

Amounts in an ABLE account (up to $100,000) do not count as a resource for Medicaid qualification purposes. ABLE accounts will be a nice benefit for clients with disabled beneficiaries, and will be used in connection with special needs trust planning.

2. Treasury-IRS Priority Guidance Plan; "BDITs"

The Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2014 was released on August 26, 2014; it is available at http://www.irs.gov/pub/irs-utl/2014-2015_pgp_initial.pdf. It includes the issuance of final regulations under §67(e) (which had already been published on July 17, 2014), and uniform basis rules for charitable remainder trusts (which had been published January 17, 2014).

The new item in last year's Priority Guidance Plan was "Revenue Procedure under §2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability." This will likely make clear that QTIP trusts can be used in connection with

portability planning even if the QTIP election is not needed to reduce the estate tax in the first decedent's estate, despite the provisions of Revenue Procedure 2001-38.

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

a. ***Unbundling Requirement Under §67(e).*** One of the items on the Priority Guidance Plan is the issuance of regulations regarding the application of §67(e) to trusts, following the Supreme Court's decision in *Knight v. Commissioner.* Proposed regulations impose an unbundling requirement on trusts to identify the portion of trustee fees and professional fees that are subject to the 2% haircut rule for the deduction of miscellaneous itemized deductions by trusts under §67(e). The IRS had issued proposed regulations prior to the *Knight* decision and in 2011 issued a new set of proposed regulations after the *Knight* case. The IRS continued its approach of imposing the unbundling requirement despite substantial criticism of those provisions in the initial proposed regulations. The IRS in Notice 2011-37 committed that it would not impose an unbundling requirement until trust and estate years beginning after the final regulations are issued.

   The IRS finalized the regulations on May 9, 2014, with very few changes from the proposed regulations. In particular, the unbundling requirement was retained. Apparently, the IRS received few comments regarding reasonable methods for allocating bundled fees. The final regulations provide three facts that may be considered (among others) in making a "reasonable" allocation:

   > Facts that may be considered in determining whether an allocation is reasonable include, but are not limited to, the percentage of the value of the corpus subject to investment advice, whether a third party advisor would have charged a comparable fee for similar advisory services, and the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions. Reg. §1.67-4(c)(4).

   The regulations state that if a bundled fee is not computed on an hourly basis, only investment advisory fees must be unbundled and made subject to the 2-percent floor. Reg. §1.67-4(c)(2).

   In the future, trustees may tend to make investments through mutual funds rather than through common trust funds or by direct investments, because the investment expense of administering a mutual fund is netted out before the taxable income from the fund is determined. Thus, there is not an issue of having a separate expense that is not fully deductible (or that is subject to the alternative minimum tax).

   The final regulations were originally effective for taxable years beginning on or after the date the regulations were published (May 9, 2014). That would cause the regulations to apply to new trusts or estates that begin in 2014 after May 9 (or estates with fiscal years beginning after May), and apparently that was not intended. The IRS on July 16,

2014 amended the effective date so that the regulations apply to taxable years of trusts or estates beginning on or after January 1, 2015.

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

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

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

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

a. ***The "New Normal."*** There is a "new normal" of estate planning in light of the (i) transfer tax certainty, (ii) large indexed transfer tax exemptions (which is, by far, the most important change), and (iii) portability provided by ATRA. (In 2001, 120,000 estate tax returns were filed, of which 60,000 were for taxable estates. In 2012, less than 4,000 taxable estate tax returns were filed. Estimates are that only about 0.14% of decedents will be subject to the federal estate tax.) Income tax changes may significantly impact trusts (causing trusts to be taxed in the highest brackets at a mere $12,000 indexed amount of trust income).

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

b. ***Planning for Married Couples Under $5 Million.*** The major focus for estate planning for couples having assets under $5.34 million ($5.43 million projected for 2015) will be (i) core dispositive planning, (ii) income tax planning (for example, achieving basis step up at death), and (iii) preservation and management of assets (including asset

protection planning and traditional elder law planning issues). Trusts may continue to be important for these clients for purposes other than saving federal estate tax (distribution management, investment management, controlling where assets ultimately pass, creditor protection, "divorce protection," etc.).

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

State transfer tax planning may still be relevant for states with a state estate tax having an exemption level that is less than the federal exclusion amount. (The state income and transfer tax planning strategies discussed in Items 4.h, 5.k, and 15 may also be appropriate for clients with under $5 million.) Ironically, it might seem that smaller estates do not need complicated planning, but these are the families that can least afford to be paying tens or hundreds of thousands of dollars in state estate taxes. (If $2 million could be sheltered from the gross estate for state estate tax purposes at the surviving spouse's death, this would result in state estate tax savings of over $100,000-based on the state death tax credit table in §2011(b) that is still used by many states that have state estate taxes.)

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

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

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

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

step-up at the surviving spouse's subsequent death. A more detailed discussion of planning for clients with under $10 million is discussed in Item 4 below, and portability is discussed in Item 5 below.

d. ***Planning for Couples Above $10 Million.*** Traditional planning strategies for large estates will continue to apply. A new wrinkle is that the gift exemption amount will increase each year with indexing (it increased by $130,000 in 2013 from $5,120,000 to $5,250,000 and increased by $90,000 in 2014 to $5,340,000) and the decision will have to be made how to best use the increased gift exemption amount each year (if at all). (The exemptions of both spouses will now cover the estates of couples with almost $11 million.)

4. Planning for Couples Having Under $10 Million

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

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

Estate planning for these clients will focus on:

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

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

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

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

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

15. Planning for clients with real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to state estate tax).

16. Planning for clients who are U.S. citizens or resident aliens who own property in other countries.

17. Planning for nonresident aliens with assets in the U.S. or who plan to move to the U.S.

18. Planning for citizens who intend to change their citizenship.

19. Planning for possible decrease in the estate, gift, and GST tax exemptions and/or increase in the transfer tax rates.

20. Planning to pay education expenses, including contributing to I.R.C. §529 plans.

21. Planning to deal with non-tax regulatory issues, such as the Patriot Act, HIPAA, and charitable governance reform.

22. Identifying guardians for minor children, if and when needed.

c. ***Portability.*** Unless the couple owns assets close to double the exemption amount and still have significant growth years ahead, the couple will likely not owe any federal estate tax, whether the credit shelter approach or portability approach is used. For these clients, the major issues are:

- Use a credit shelter trust up to the state exclusion amount (if the state has an estate tax and if the state does not recognize portability [Delaware and Hawaii (and Maryland beginning in 2019) do recognize portability for their state estate taxes]);
- Leave qualified retirement plan and IRA benefits outright to surviving spouses (to take advantage of the longer-term payout opportunities afforded to spouses);
- Trust vs. no trust planning (*i.e.*, are the non-tax advantages of trusts important to the client);
- Blended family concerns—use the credit shelter trust approach (see Item 5.f regarding blended family planning complexities);
- If trusts will be used, is it important for both the surviving spouse and descendants to be discretionary beneficiaries after the first spouse's death? (if so, use credit shelter planning);
- Remarriage possibility—a significant possible disadvantage (especially for younger clients) is that the surviving spouse may remarry and the new spouse may die before the surviving spouse, resulting in a loss of the DSUE amount from the first deceased spouse (unless the surviving spouse made a gift

utilizing that DSUE amount before the new spouse predeceased the surviving spouse);

- Overall fixed income portfolio allocation—if the credit shelter trust could be funded with the fixed income portion of the overall portfolio, there are minimal concerns of losing basis step-up at the second spouse's death because there will likely be few unrealized gains in the trust;
- Asset protection significance—assets that are protected from creditor claims under state law (such as tenants by the entireties, retirement accounts, homestead property and life insurance) can be left in those forms with portability to maintain the asset protected status of the assets; and
- Basis issues—cannot be ignored (but ways of obtaining basis step up even with credit shelter trust planning may be possible);

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

d. ***Blended Families.*** Over 29 million parents (13 percent) are also stepparents to other children. Forty percent of married couples with children (*i.e.*, families) in the U.S. are step-couples (at least one partner has a child from a previous relationship; this includes full and part-time residential stepfamilies and those with children under and/or over the age of 18). A very large block of clients will have blended family issues. (And some planners have noted that every family is just one death and remarriage away from being a dysfunctional family.)

e. ***Titling of Assets.*** If clients rely on portability to take advantage of both spouses' exemption amounts, re-titling of assets to assure that each spouse has sufficient assets to fund a credit shelter trust is no longer necessary. (That may still be a consideration, though, for clients living in decoupled states that have relatively low state exemption amounts.) Tenancy by the entireties designations may be more widely used than in the past to take advantage of the asset protection features of that designation. Also give consideration to creditor concerns—be wary of leaving the bulk of the marital assets in the name of the spouse with the greatest liability exposure. Clients feel more comfortable seeing both of their names on the trust property.

f. ***Domicile and Residence.*** Domicile (which controls for estate tax purposes and depends on the client's intent) and residence (which controls for income tax purposes) concerns may become relatively more important in the overall planning to avoid state estate taxes and state income taxes. Especially if a client lives in one state and works in another state, be wary of owning a vacation home or condo in the employment-state; that might help avoid double taxation.

g. ***Review and Repurpose Pre-existing Planning.*** Existing estate planning documents should be reviewed from a new perspective. How will formula clauses operate in light of state estate taxes, higher exclusions and lifetime gifts? Will much (or all) of the estate be left to a credit shelter trust that no longer will generate federal estate tax savings? If so, substantial state estate taxes may be generated at the first spouse's death. If clients have made large gifts in the past, trusts should be reviewed to determine the operation

of those trusts. Is the trustee structure and are other provisions of the trusts working appropriately, or should modifications be made? Should adjustments be made to the estate plan in light of the prior gifts and now larger federal exemptions? Should expectations regarding future gifts be clarified with family members?

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

past the QPRT term for no or nominal rent (perhaps with remaindermen giving consents), to raise an argument of inclusion of the residence in the gross estate under §2036 as a transfer with an implied agreement of retained enjoyment.

- *Existing Bypass Trusts.* Even though there may be no federal estate tax advantages of existing bypass trusts, the trust may be helpful as an income shifting tool by making distributions not to the surviving spouse but to descendants (as well as being helpful for non-tax purposes).

h. **State Estate Tax Planning.** There is significant planning complexity in decoupled states. About 20 states have "decoupled" from the federal estate tax. In most decoupled states, the maximum rate is 16% (in Washington state, it is 19%). Many states have exemption amounts much lower than the federal exclusion amount. The exemption is currently $1 million in the District of Columbia, Maryland, Massachusetts, Minnesota, New York and Oregon (and is just $675,000 in New Jersey).

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

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

death, and there would likely be little capital appreciation to worry about losing basis step-up at the second spouse's death.

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

- *Outright Bequest to Spouse Followed by Gift to Trust in DAPT State.* For couples with under $10 million, the surviving spouse will likely want to be a potential discretionary beneficiary of the gift amount (if the spouse is willing to make a gift at all). A gift to a trust under the laws of a domestic asset protection trust (DAPT) would allow that as a possible strategy. (There is uncertainty as to whether or not a domiciliary in a non-DAPT state can establish such a trust in a DAPT jurisdiction and have it respected so that his or her claimants cannot reach the trust assets. *See* Shenkman & Rothschild , *Self-Settled Trust Planning in the Aftermath of the Rush University Case*, Leimberg Asset Protection Planning Newsletter (Dec. 6, 2012).
- *Outright Bequest to Spouse Followed by Non-Qualified Disclaimer to Use DSUE.* The surviving spouse could make a non-qualified disclaimer of a portion of the estate, with the assets passing to a trust for children (or if in a DAPT state, to a trust with the spouse as a discretionary beneficiary). Because the disclaimer is non-qualified, it would not disqualify the state estate tax marital deduction.

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

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

include gains realized during the year. See Item 9.m-n for a discussion of income shifting concerns for capital gains in trusts.

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

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

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

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

- *Tenancy by the Entireties.* Almost half of the states provide asset protection for assets held by the spouses in a tenancy by the entireties.
- *Homestead.* A number of states provide creditor protection for the personal residence claimed as a homestead.
- *Qualified Retirement Plans.* Assets in qualified retirement plans are generally exempt from creditors' claims.
- *Domestic Asset Protection Trusts.* For a discussion of self-settled trust states, the §2036 issues regarding the creation of domestic asset protection trusts (DAPTs) in which the settlor is a discretionary beneficiary, and the incomplete gift issues for DAPTs, see Item 17 of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.Bessemer.com/Advisor.
- *Selection of Trustee Concerns*. To create spendthrift protection for beneficiaries other than the settlor, the law is unclear as to whether the beneficiary can be assured of spendthrift protection if he serves as the trustee with the ability to control distributions to himself. A creditor would be able to force the trustee to make distributions that the beneficiary, in his individual capacity, could compel. Whether creditors could compel distributions where the trustee is authorized to make distributions under an ascertainable standard is not clear. *Contrast* RESTATEMENT (THIRD) OF TRUSTS, §60, Comment g, Ex. 9 (trustee can make distributions to herself for "support, education, and care, taking account of the beneficiary's other resources if and to whatever extent the trustee deems appropriate"; beneficiary's creditors "may reach the maximum amount of trust funds that she may, without abuse of her discretion, distribute to herself for authorized purposes …") *with* UNIF. TRUST CODE §504(b)("Except as otherwise provided in subsection (c), whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion, even if: (1) the discretion is expressed in the form of a standard of distribution; or (2) the trustee has abused the discretion.") & §504(e)("If the trustee's or cotrustee's discretion to make distributions for the trustee's or cotrustee's own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim were the beneficiary not acting as trustee or cotrustee."). If creditor protection is important, to be conservative, a trustee other than the beneficiary should control distribution decisions to the beneficiary. However, it is certainly possible that a court would recognize spendthrift protection where the beneficiary is the trustee with an ascertainable distribution standard, and some states now have statutes making clear that a beneficiary's creditor cannot reach trust assets merely because the beneficiary is the cotrusteee having the power to make distributions to himself or herself under an ascertainable standard. *E.g.*. TEX. PROP. CODE §112.035(f); ILLINOIS 735 ILCS 5/2-1403. Other states have adopted their versions of §504 of the Uniform Trust Code.

E.g., FL. TRUST CODE § 736.504(2). In situations where creditor protection is not an immediate concern, the planner may, in weighing the issues, decide to name a beneficiary as trustee or co-trustee, but impress upon the beneficiary that he or she should resign as trustee as soon as possible when the beneficiary realizes that there may potentially be creditor issues in the future. (The beneficiary cannot wait too long in resigning, or else the creditor may raise arguments that the act of resigning is effectively a transfer in fraud of creditors rights under the Fraudulent Transfer Act, and that the creditor should still be able to reach the trust assets.) An alternate approach, to be conservative, would be to provide for the beneficiary to serve as the "investment co-trustee" and to name a third party as the "distribution co-trustee" (and perhaps even give the beneficiary the power to remove and replace the "distribution co-trustee," which some commentators would include only if distributions were subject to an ascertainable standard.)

- *Divorce Protection*. Estate planning attorneys typically spend as much time discussing protecting beneficiaries from creditors generally as planning for protection from a spouse in a divorce action. That is ironic because relatively few beneficiaries have experienced creditor attacks on their trusts, but divorce actions are common. Planners should spend more time discussing how to protect beneficiaries from divorce claims. Traditional trust drafting does not do that. Planners often focus on providing control, flexibility and tax savings for the beneficiary. Those provisions hurt with respect to divorce claims. The more control/interest the beneficiary has in the trust, the more likely it will be treated as marital property.

  If the beneficiary (i) has a special power of appointment, (ii) is the trustee, (iii) can make distributions to himself for health, education, support and maintenance, and (iv) can appoint an independent trustee who can make distributions for any reason, the beneficiary has a great deal of flexibility and control while still having the trust assets omitted from the beneficiary's gross estate. But a divorce judge will likely view the trust assets as the beneficiary's "property" for purposes of the division on divorce. The attorney can argue the importance of fiduciary duty, but the judge will just view that as an attempt to cheat the divorced spouse.

  On the other hand, if there is an independent trustee and the trustee has total discretion in making distributions without any requirement to make support distributions, that interest is more likely to be viewed as not constituting property of the beneficiary for purposes of the divorce action.

  Planners should have more detailed discussions with clients about priorities, and whether "divorce-proofing" the trust is more important than giving the beneficiaries control and flexibility.

  Section 504(c)(1) of the Uniform Trust Code provides that to the extent a trustee has not complied with a standard or distribution or has abused a discretion, "a distribution may be ordered by the court to satisfy a judgment or

court order against the beneficiary for support or maintenance of the beneficiary's child, spouse, or former spouse." Some states have statutes that are much more protective of the interests of beneficiaries in trusts against the claims of former spouses in divorce actions. SOUTH DAKOTA CODIFIED LAWS §§ 55-1-24(6) & 55-1-42; NEVADA REVISED STATUTES §§163.417 & 166.080. However, there is limited ability to select the governing law of those states in order to protect trust beneficiaries against divorce claims because the court where the divorce is located will decide what is "property" for purposes of the equitable distribution in a divorce. Because of the uncertainties about where married beneficiaries will live and about the effectiveness of governing law provisions in trusts, planners cannot give assurances that trusts are "divorce-proof." They can discuss the issues and strategies used to provide as much protection as possible, but cannot give divorce-proofing assurances.

I. ***Selection of Trustee.*** One commentator has observed that the Most disrespected decision in estate planning" is the selection of who will serve as trustee and as successor trustees. Charles A. Redd, *The Most Disrespected Decision in Estate Planning*, TRUSTS & ESTATES 13-14 (July 2014). Mr. Redd suggests various characteristics that should be considered.

"**Does the individual under consideration as trustee possess sufficient expertise and the necessary experience to do the job?** …

Is the proposed trustee independent, or does the proposed trustee have an inherent conflict of interest? …

Does the trustee have an appropriate fiduciary demeanor? Trustees often must make difficult choices….[A] conclusion may please one or more beneficiaries while causing distress to others. To be successful, a trustee must possess the judgment to make prudent assessments and have the resolve to make and defend decisions in the face of possibly aggressive opposition.

Will the trustee being considered be around long enough to see the job through? …

Where's the proposed trustee located? …

Will the trustee expect to be paid? The cost of trust administration is an important factor. However, trust administration is never free. …

Is the trustee accountable? … If a corporate fiduciary is serving or if an individual trustee is bonded (which is exceedingly difficult to accomplish), the answer is 'yes.' Otherwise, depending on the amounts of the losses, the answer could easily be 'no.'

Critical Element. Designating initial and successor trustees is among the most critical elements of the estate-planning process. It's often not treated as such but should be. The best estate planners understand this reality and skillfully guide their clients through a thoughtful and deliberate trustee selection process." *Id.*

m. ***Intra-Family Loans.*** Couples with under $10 million are likely to make more use of loans to assist family members than outright gifts. The loans must be structured as a bona fide loan (*e.g.*, note, expectation of repayment, etc.).

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

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

5. PORTABILITY

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

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

- The portability election is made by the executor's filing a timely and complete Form 706 (if the estate tax return is not timely filed and if the estate is small enough that no return would otherwise be required, Rev. Proc. 2014-18 (issued January 27, 2014) allows a relief procedure for certain estates, described in paragraph b below);
- In most cases there will be no need to list values of assets passing to a surviving spouse or charity on the "timely and complete" Form 706 if the estate was not otherwise required to file an estate tax return (but the return must include an estimate of the total value of the gross estate within specified ranges, including assets passing to a spouse or charity);
- The surviving spouse's DSUE amount is not subject to being reduced if Congress later reduces the basic exclusion amount;
- The regulations adopt the "Example 3" approach of the Joint Committee Technical Explanation, negating any "privity" requirement in calculating the DSUE amount (an approach adopted legislatively by ATRA);

- If the decedent made gifts requiring the payment of gift tax, the excess taxable gift over the gift exemption amount (on which gift tax was paid) is not considered in calculating the DSUE amount;
- The surviving spouse can use the DSUE amount any time after the decedent's death, assuming the portability election is eventually made by the executor;
- Any gifts made by the surviving spouse are first covered by the DSUE amount, leaving the spouse's own exclusion amount to cover later transfers;
- DSUE amounts from multiple spouses may be used to the extent that gifts are made to utilize the DSUE amount from a particular spouse before the next spouse dies; and
- If the estate leaves assets to a QDOT, the surviving spouse cannot use the DSUE amount until the QDOT is fully distributed (or terminates at the surviving spouse's death).

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

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

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

Background. Section 2010(c)(5)(A) requires that the portability election be made on an estate tax return for the decedent whose unused exclusion amount is being made available to the surviving spouse, and for the election to be effective the return must be filed within the time prescribed by law (including extensions) for filing the estate tax return. For estates having a gross estate and adjusted taxable gifts under the basic exclusion amount, no return is required to be filed under §6018(a) (so there is no prescribed filing date). The portability regulations add that for those estates under the filing threshold limit, if the estate makes the portability election it will be considered to be required to file a return under §6018(a), so the due date is 9 months after the decedent's date of death (or 15 months if the return is extended). Because there is no statutory filing deadline for estates under the filing threshold, the IRS has the authority to grant extensions of time for filing the return under Reg. §301.9100-3 to make the portability election. The IRS has granted various such extensions for estates under the filing threshold who have made formal letter ruling requests for extensions pursuant to Reg. §301.9100-3.

Overview of Rev. Proc. 2014-18. Rev. Proc. 2014-18 (issued January 27, 2014) allows a simplified relief procedure (with no user fee being required), generally adopting one of the recommendations made by the Section of Real Property, Trust and Estate Law of the American Bar Association in comments filed with the IRS on September 27, 2013 (the ABA RPTE Section Comments are described in Item 8.l of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.Bessemer.com/Advisor). The relief measure assists those estates

below the filing threshold who did not file the election return timely because they were unaware of the need to file the return in light of the newness of the regulations and also those same-sex couples who were retroactively recognized as spouses in Rev. Rul. 2013-17, 2013-38 I.R.B. 201.

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

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

- The decedent of the estate
  - has a surviving spouse,
  - died after 2010 [portability first became available for decedents dying after 2010] and on or before December 31, 2013, and
  - was a citizen or resident of the United States on the date of death;
  - The estate was not otherwise required to file an estate tax return because the value of the gross estate and adjusted taxable gifts was less than the basic exclusion amount [$5 million in 2011, $5.12 million in 2012, and $5.25 million in 2013];
  - The estate did not file an estate tax return within the time specified in Reg. §20.2010-2T(a)(1) for filing the estate tax return to elect portability [i.e., the 9-month (or 15-month, if extended) period for filing the estate tax return; if a timely return was filed, that return either automatically made (or affirmatively declined to make) the portability election, Reg. §20.2010-2T(a)(3)(i)]; and
  - The estate satisfies the following procedural requirements—
  - The executor (or other person permitted to make the election) filed a "complete and properly-prepared Form 706" (i.e., meeting the requirements of Reg. §20.2010-2T(a)(7) [which allows simplified reporting procedures for estates that are below the filing threshold]) on or before December 31, 2014; and
  - The return must state at the top of Form 706 "FILED PURSUANT TO REV. PROC. 2014-18 TO ELECT PORTABILITY UNDER §2010(c)(5)(a)."
- The IRS will send an estate tax closing letter acknowledging receipt of the Form 706; but if it is subsequently determined that the estate was over the filing threshold the automatic grant of extension is "deemed null and void."

Limitations on Refund Claims by Surviving Spouse's Estates. If the surviving spouse has subsequently died after the decedent who is making the late election, Rev. Proc. 2014-18 addresses the limitations period for requesting a credit or refund. The surviving spouse must file a claim for refund before the general refund limitation period. For example, assume S1 died on January 1, 2011, S2 died January 14, 2011,

and the Form 706 for S2 was filed and tax was paid on October 14, 2011 (without taking advantage of unused exclusion amount from S1, which would have eliminated the estate tax totally for S2). The estate of S2 must file a claim for refund 3 years after filing the Form 706 (*i.e.*, by October 14, 2014), even if the estate of S1 does not file the return making the portability election or receive a closing letter regarding such election before that date. The claim will be a protective claim for refund pending the determination that the estate of S1 is ultimately determined to have elected portability pursuant to the extension measures under the new procedure.

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

Observations:

- *Welcome Relief.* This procedure is quite welcome. It will prevent estates who meet the requirements of the procedure from having to pay the $10,000 filing fee (which can be reduced for certain taxpayers) for making the letter ruling request for extension pursuant to Reg. §301.9100-3.

- *Key Dates.* Two important due dates are specified: (1) the Form 706 making the portability election must be filed by December 31, 2014; and (2) estates with any pending ruling requests for extending the date to file the return must do so by March 10, 2014 to receive a refund of its user fee (and perhaps even before that date—so file the notification to withdraw the ruling request as soon as possible). Another date is specified if the surviving spouse has died and paid estate tax—the refund claim (based on having the first decedent's DSUE amount, which would reduce the surviving spouse's estate tax) must be filed within the normal 3-year period of filing the surviving spouse's return.

- *Procrastination Pays!!!* Estates that realized they had not timely filed the return to make the portability election and that filed a ruling request (and paid the user fee) and received the ruling apparently will not get their money back. (Shame on them for being responsible and proactively filing for relief under Reg. §301.9100-3 as soon as reasonably possible.)

- *Estates That Filed Returns After Due Date But Have Not Filed Ruling Request*. In light of the uncertainty surrounding the filing date issue, some estates may have simply filed the estate tax return late making the portability election, but have not yet filed a ruling request for an extension of time to file late. Those returns obviously would not have included the required notice at the top of the return. Those estates are not prohibited under the procedure from using the extended due date by reason of the earlier-filed return, because it was not

timely filed. To be conservative, any estate in this situation should re-file the estate tax return, with the required notice added at the top of the return.

c. ***Portability Decision is Complex.*** Because the portability provisions have now been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. From the planner's perspective, this is a more complex decision involving a wide variety of factors that might apply at the first spouse's death (including the surviving spouse's age and life expectancy, whether assets will likely appreciate substantially, whether assets may be sold during the spouse's lifetime, whether assets will be held long-term even after the surviving spouse's death, whether the assets are those kinds that have larger than normal capital gains rates, the states where the beneficiaries live and their estate and income tax rates, whether there will likely be net consumption of the estate, whether it is important to use trusts that allow both the surviving spouse and children to be potential beneficiaries, etc.). For a discussion of client characteristics to consider in making the credit shelter trust vs. portability decision, see John Bannen and Kristin Occhetti, *The DSUE Coin Flip—Factors to Consider When Advising a Surviving Spouse on Portability,* TRUSTS & ESTATES 17 (Aug. 2014).

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

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

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

d. ***Credit Shelter Trust Approach Primary Advantages.*** Major advantages of the credit shelter approach include: (i) desirability of omitting future appreciation from the estate, (ii) being able to take advantage of state estate tax exemptions (perhaps using a credit shelter trust only up to the amount of the state exemption [Delaware and Hawaii (and Maryland beginning in 2019) recognize portability for state estate tax purposes]), (iii) maximizing use of the GST exemption, (iv) being able to include the spouse and other persons as trust beneficiaries, (v) avoiding (or minimizing) inequities in a blended family situation (including the inherent possibility of the creation of a blended family by the surviving spouse's remarriage), and (vi) non-tax advantages of trusts (if a client wants to use a trust for non-tax advantages in any event, and will not have the simplicity of outright transfers, the client might decide to use the credit shelter trust for its advantages rather than using a QTIP trust).

A prime tax advantage of using portability is the second basis step-up at the second spouse's subsequent death. However, using credit shelter trusts may not cause a loss of basis step-up if the amount in the credit shelter trust is about the amount that the client would allocate to fixed income assets in the overall asset allocation for the combined portfolio of marital assets. The credit shelter trust could hold the fixed income assets and the surviving spouse could hold the equity portion of the overall

portfolio (and there would be a basis step-up for the appreciation that would be included in the surviving spouse's gross estate at his or her subsequent death); there would not be substantial capital gain appreciation in the credit shelter trust. Marty Shenkman (Paramus, New Jersey) refers to this as "asset location" planning.

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

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

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

For couples with approximately $7 million, it is highly likely that with portability, there will be no federal estate tax at the second spouse's death; planning to be able to take advantage of the second basis step-up comes without giving up any federal estate tax savings. (Some planners jokingly would call this "free-basing.")

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

f. ***Blended Family Situation.*** In a "non-standard" family situation ("not Ward, June, Wally and the 'Beav'- but the Brady bunch") situation, substantial inequities may result if the credit shelter approach is not used. The following observations and examples are based on observations from a presentation by Thomas Abendroth and Barbara Sloan at the ACTEC 2013 Fall Meeting. Potential problems can arise if there

is hostility between the executor (perhaps a child by the decedent's prior marriage) and the surviving spouse's family. The executor may try to "extort" consideration for making the portability election. Or the executor may be unwilling to bear the expense of filing an estate tax return to make the election. (The will could be drafted to provide that the executor would not be required to make the portability election unless the surviving spouse pays the expenses of filing the estate tax return.)

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

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

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

Possible planning alternatives to avoid this situation are (i) use a premarital or post-nuptial agreement in which the parties agree that a decedent-spouse's executor will make the portability election only if the surviving spouse agrees to waive the §2207A reimbursement right from the decedent-spouse's QTIP trust, or (ii) if a marital agreement is not possible, the decedent-spouse's executor might agree to make the portability election only if the surviving spouse agreed to waive the §2207A reimbursement right (perhaps a capped waiver, as described below, in case the QTIP trust grows to more than the DSUE amount). (Agreeing to make the QTIP election only if the surviving spouse agreed to waive the reimbursement right might conceivably create concerns as to whether the QTIP election was valid, and using the conditional portability election is preferable to a conditional QTIP election.)

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

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

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

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

I, Mary Doe, in exchange for the Executor making a portability election in the Estate of John Doe, hereby waive any right of reimbursement under Section 2207A of the Internal Revenue Code with respect to the Mary Doe Marital Trust (the "Marital Trust"), but only to the extent of the federal estate tax assessed against my estate attributable to the value of the Marital Trust assets equal to an amount up to but not exceeding the amount of the deceased spousal unused exclusion amount (the "DSUE amount") as finally determined from the estate of John Doe (whether or not such DSUE amount is available to my estate at the time of my death). The amount of the reimbursement right from the Marital Trust that is waived shall be determined by the following calculation process. (1) First, determine the amount of reimbursement that would be due to my estate from the Marital Trust under Section 2207A but for this waiver (the "Section 2207A reimbursement amount"). (2) If the value of the Marital Trust assets for estate tax purposes at my death is equal to or less than the DSUE amount, the full Section 2207A reimbursement right is waived. (3) If the value of the Marital Trust assets for estate tax purposes at my death is more than the DSUE amount, the amount of the reimbursement right that is waived is the Section 2207A reimbursement right multiplied by a fraction, the numerator of which is the DSUE amount and the denominator of which is the value of the Marital Trust for estates purposes at my death. [**ALTERNATE APPROACH FOR CLAUSE (3)**: (3) If the value of the Marital Trust assets for estate tax purposes at my death is more than the DSUE amount, enough of the Section 2207A reimbursement amount is waived such that my estate will bear no more federal estate tax than if the Marital Trust assets were not included in my gross estate for federal estate tax purposes.]

See Charles Granstaff, *Portability + QTIP—A Happy Couple or a Recipe for Family Discord?,* TRUSTS & ESTATES 22, 25 (Aug. 2014).

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

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

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

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

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

(1) Disclaimer approach - rely on a disclaimer provision (allowing a surviving spouse to disclaim an outright bequest with a provision that the disclaimed assets pass to a bypass trust), or

(2) QTIPable trust approach - portability would be used if a full QTIP election is made (and the first deceased spouse's GST exemption could be used by making a reverse QTIP election under §2653(a)(3)), and a bypass trust approach would be used if a partial QTIP election is made with a "Clayton" provision (so that the unelected portion would have more flexible distribution provisions than a single–beneficiary mandatory income interest trust for the surviving spouse).

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

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

- *QTIPable Trust Approach Additional Flexibilities.* Even though the QTIP approach may seem more complicated to clients, in many ways, the QTIPable trust approach affords greater flexibilities.
- The executor has up to 15 months to decide whether to make the QTIP election and over what portion of the trust.
- The QTIP election could be made by a formula, thus providing a "savings clause" to assure that no estate tax would be paid at the first spouse's death.
- If the QTIP election is made, the executor could make the "reverse-QTIP" election and allocate the decedent's GST exemption to the trust.
- If the state recognizes a "state only QTIP election," having assets in the QTIP trust may make the planning easier to fully utilize the first spouse's exemption amount without paying any state estate taxes at the first spouse's death.
- Any unelected portion could pass to a standard bypass trust under a "Clayton" provision. (Some planners believe that the surviving spouse should not be the executor making the QTIP election if there is a Clayton provision. The IRS might argue that if the spouse makes the election, the spouse makes a gift of some or all of the assets that would have been in the QTIP trust. Panelists take the position that there *should* be no gift tax consequences; this should be no different than other post-death tax elections [such as where to deduct administrative expenses] that have a direct impact on the amount of assets that pass to the credit shelter trust and to the surviving spouse [or QTIP trust]). However, if the surviving spouse is the executor making the Clayton election, uncertainty would exist for years as to whether a gift results and whether that causes §2036 inclusion issues for some portion of the credit shelter trust.) (As an aside, Jeff Pennell thinks the preferable plan is generally to structure the credit shelter so that it has "QTIPable terms"—mandatory income interest for

spouse as the exclusive beneficiary. That would, for example, facilitate getting a PTP credit if the surviving spouse were to die shortly after the first spouse to die. Other panelists observe that clients like being able to make transfers to children and the use of the children for income shifting purposes.)

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

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

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

Approach Starting With Outright Bequest. The plan could start with an outright bequest to the surviving spouse, with provisions that if the spouse disclaimed, the assets would pass to a QTIPable trust, and that if the spouse disclaimed his or her interest in the QTIP trust, the assets would pass to a bypass trust. This affords a great deal of flexibility.

- The spouse could decide not to make any disclaimers and keep the assets, and the executor would then make the portability election.
- Alternatively, the spouse could disclaim some or all of the outright bequest and the disclaimed assets would pass to the QTIPable trust. The executor would have up to 15 months after the date of death (if the estate tax return is extended) to decide whether to make the QTIP election (or whether to make a partial QTIP election). If the QTIP election is not made, the unelected portion could pass to the bypass trust. If the QTIP election is made, the executor could make the reverse-QTIP election and allocate the decedent's GST exemption to the trust.

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

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

- The decedent's will might make a bequest first to a QTIP trust.
- The executor would have 15 months to decide whether to make the QTIP election over all or a portion of the QTIP trust. Any unelected portion could pass to a bypass trust under a "Clayton" provision. If the QTIP election were made, the portability election would be made for the decedent's unused exemption amount. This "reverse-disclaimer" approach has the significant advantage of allowing the surviving spouse to have a testamentary limited power of appointment over both the QTIP trust and the bypass trust.
- If the spouse disclaims an interest in the QTIP trust, the disclaimed assets would pass outright to the surviving spouse.
- This is a twist from the typical operation of a disclaimer, but the disclaimer rules do not seem to preclude this sort of approach in which the disclaimant receives a greater interest in the property than under the bequest that was disclaimed. Under §2518(b)(4)(A), the disclaimed assets can pass to the surviving spouse.

- Potential concerns are (1) that the disclaimer would not be "qualified" because the spouse would own the assets and direct who receives them, and (2) the spouse might be treated as making a gift if the spouse does not disclaim. These concerns and possible responses are discussed at Item 8.h of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.Bessemer.com/Advisor.

- An alternate approach is to provide that disclaimed assets would pass to a credit shelter trust.

j. ***Should the Portability Election be Mandated? Who Pays the Filing Expense?*** This is particularly important for second or (or third) marriages. If clients are asked if the surviving spouse should be able to use any excess exclusion, most will say yes. If clients are asked whether the surviving spouse should have to pay the first-decedent's family to be able to use the unused exclusion amount, most will say no. The planner may discuss with the clients whether the spouse of the decedent's estate should bear the expense of filing the estate tax return to make the election.

Similarly, consider these issues in pre-marital agreements.

Walton v. Estate of Swisher, 3 N.E.3d 1088 (Ind. App. 2014) is an example of negotiations that may arise regarding the portability decision. In that case the surviving husband agreed with the decedent's daughter to pay some of the deceased wife's medical expenses and to pay her estate $5,000. The husband died the following year. When the daughter learned of the estate tax savings that resulted from the use of the wife's unused exclusion amount, she sued his estate for $500,000 under an unjust enrichment theory. The court concluded that no additional amount was owed, and the original agreement with the daughter was unambiguous and did not result in unjust enrichment.

The fact that this claim was even made raises interesting issues for planners:

- The importance of covering the filing/ portability issue in the couple's estate planning documents or marital agreement, including who pays for the cost of filing the return if it will be filed just to make the portability election;
- The possibility of opening a probate estate for the purpose of having an executor who can negotiate for the preparation of an estate tax return;
- Whether the surviving spouse is the appropriate person to serve as executor;
- The value of the right to file the estate tax return and make the portability election and whether the executor should negotiate to receive payment for making the election; and
- The importance of the surviving spouse disclosing the potential benefits of portability when negotiating a payment for filing the return.

k. ***State Estate Tax Planning Implications of Portability.*** The following observations are based on comments and examples from a presentation by Thomas Abendroth and Barbara Sloan at the ACTEC 2013 Fall Meeting. The detailed examples and analysis

are discussed at Item 8.j of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.Bessemer.com/Advisor.

- *Avoiding state estate tax at first spouse's death.* Using a credit shelter trust for the full amount of the federal exemption amount at the first spouse's death might generate significant state estate taxes, which could be avoided by using portability. For example, fully funding a bypass trust in New York, with its $1 million exemption amount, would cost about $431,000 in New York state estate tax at the first spouse's death. Perhaps a bypass trust would be funded with only the amount of the state exemption.
- *Few states have state gift taxes.* If bequests are made outright to the surviving spouse, the surviving spouse could make gifts, which are not subject to state estate or gift taxes in most states. Only one state (Connecticut) has a gift tax, and a few more have "contemplation of death" state estate tax provisions for transfers within a certain period of time prior to death.
- *State death tax portability*. Delaware and Hawaii (and Maryland beginning in 2019) have adopted a portability concept for their state estate taxes. Their tax provisions make reference to the federal "applicable exclusion amount" (which includes the DSUE amount).
- *State estate tax implications for clients who have made substantial prior gifts.* If an individual has made significant lifetime gifts, the amount that can be funded into a bypass trust at the individual's death without imposing a state estate tax may be relatively insignificant. For example, if an individual has previously made $5.0 million of gifts and died in 2013 in a state with a "pick-up tax" based on the table in §2011 when the federal exclusion amount had increased to $5.25 million, an amount equal to $100,000 would pass to the credit shelter trust under a standard formula that leaves as much as possible to the credit shelter trust without generating a state or federal estate tax. To avoid the creation of such small trusts, removing the formula credit shelter bequest from the will may be prudent, and allow any unused applicable exclusion amount to pass to the surviving spouse with a portability election.
- *Clients in non-tax states owning real estate in decoupled states*. Clients living in states without state estate taxes may nevertheless have to pay state estate tax if they own real estate in states that have a state estate tax. This may be the case even if the real estate in the other state does not exceed the exemption for that state; many states calculate the state estate tax that would apply on the entire estate, wherever located, and impose a tax that is proportionate to the amount of the estate represented by the in-state real property.
- For further discussion of planning alternatives to address state estate taxes, see Item 4.h.

6. Estate and Income Tax Intersection—Basis Planning for Larger Estates

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

a. ***Historical Approach.*** Planning approaches in 2001 included: (1) use the applicable exclusion amount as quickly as possible during life, (ii) avoid estate tax inclusion at every generation, (iii) the basis step-up at death was less important because of low capital gain rates, (iv) income tax considerations were secondary in estate planning, and (v) the state of one's residence had no significant effect on the estate plan (there was an enormous amount of uniformity in state estate tax costs).

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

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

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

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

   - Estate planning is infinitely more complicated than in the past, depending on a wide variety of variables such as how long the client lives, spending, the size of the estate, investment return expectations, income tax character of assets, the expected timing of the sale of assets, investment and non-investment income relative amounts, the state of the residence of the grantor and beneficiaries, expected inflation, etc.)
   - Keep the applicable exclusion amount as much as possible, using zeroed out transfer strategies instead of gifts. "Don't ever ever ever use the applicable exclusion amount during the lifetime of your client" (though Paul Lee backs off

of that and says that lifetime giving can make sense in some situations, for example with high basis assets near one's death in order to save state estate taxes;
"you must convince yourself that this is a good use of the applicable exclusion; don't throw it away as quickly as we have done before").

- Tax basis management will be a crucial part of estate planning and should be considered in tandem with potential transfer taxes in making planning decisions.
- Estate tax *inclusion* can save more in income taxes if a decedent has excess exclusion amount that would otherwise be unused.
- The state of residence of the grantor and beneficiaries becomes very important, giving rise to different types of planning. Planners must ask their clients where they will likely live when they die and where their children and grandchildren likely will live.

d. ***Use Zeroed Out Transfer Planning.*** Estate tax savings from transfer planning occurs only with respect to the future income or appreciation that is removed from the client's estate. Sales to grantor trusts have basically the same advantage, except that it is only the future income and appreciation above the very low AFR interest rate threshold that is transferred. If an asset grows at 10%, making a $5 million gift will remove $500,000 from the estate in the following year. The same $500,000 amount can be removed from the estate by selling an asset for $7 million, which would grow to $700,000, or a net of $500,000 after paying $200,000 of interest. Two advantages result: (1) The applicable exclusion amount is retained to be able to shelter appreciated assets that are in the gross estate at death; and (2) the applicable exclusion remains in the unlikely event that the transferred assets goes down in value instead of appreciating.

e. ***Consider Tax Nature of Assets.*** Some assets do not benefit from a basis step-up, including cash and income in respect of a decedent assets (*e.g.*, retirement plan assets). At the other end of the spectrum, the sale of some assets generates a tax at ordinary income rates (*e.g.*, creator-owned copyrights, trademarks, patents and artwork). Another type of high-tax asset is a "negative basis" commercial real property limited partnership interest (where the real estate has been fully depreciated and the developer has withdrawn cash from the partnership). The calculations also differ depending on the state where the individual lives. Measuring the transfer tax against the potential income tax savings will vary for these different types of assets.

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

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

f. ***Forcing Estate Inclusion.*** If a beneficiary has excess exclusion amount that would be unused, including an appreciated asset in the beneficiary's estate will result in a basis step-up without any estate tax cost. One way of achieving this would be to have a formula general power of appointment, but Paul Lee advises not to use formula general powers of appointment. He thinks it cannot be written with precision to get the basis step up on the "right" assets. Furthermore, arguments could be made that the formula general power of appointment is subject to conditions that would cause the power not to exist under §2041 (citing to PLR 8516011, TAM 8551001, and *Estate of Kurz v. Commissioner*, 68 F.3d 1027 (7th Cir. 1995)). "Don't waste your nonbillable time trying to write this formula." (Other planners believe that defining the amount of the formula general power of appointment can be achieved. One alternative might be to use a formula to determine which particular assets would receive the basis step up in a general manner even if that does not result in precisely the optimal income tax advantage. For further more detailed discussion about formula general powers of appointment see Item 7.e and Appendices A & B below.)

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

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

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

   > Jenny owns the stock in a closely held business that she thinks is about to explode in value. Her mom Mary's net worth is perhaps $10,000. Jenny recapitalizes the company so that it has 1 voting share and 999 non-voting shares. She then sets up an IDGT for Mary's benefit, and sells the non-voting stock to the trust for its current appraised value of $1 million. She uses a

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

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

h. ***Income Splitting.*** Income splitting will become more important, in light of the increased tax rates for high bracket taxpayers and the 3.8% tax on net investment income that applies to taxpayers with adjusted gross income above a certain (non-indexed) threshold. This can be particularly important for trusts, which become subject to the high brackets at only $12,150 of taxable income (in 2014) (projected to increase to $12,300 in 2015). Over a period of years, the tax savings can be substantial; however, income splitting that involves direct splitting with beneficiaries must be viewed under a prism of reality—as a practical matter the younger generations may consume the assets and there will not be a dramatic increase in wealth available to the family decades later. That may be avoided by using distributions of interests in partnerships or S corporations that cannot be converted into ready cash flow by the younger generation beneficiaries.

i. ***Asset Swapping.*** Planners may recommend that clients annually consider whether high basis assets should be "swapped" into a grantor trust (using the substitution power) in return for low basis assets that the client could own at death to receive a stepped-up basis at death.

j. ***Using Partnerships to Change the Basis of Non-Depreciable Assets Without Death or a Taxable Event.*** Using partnerships is the only way proactively to change the tax basis of non-depreciable assets without death or a taxable event. (Paul Lee calls Subchapter K "Subchapter Kryptonite.") Assume a partnership has older and younger partners and high-basis and low-basis assets. A passive approach is to allow the older partner to die and make a §754 election to get an inside basis adjustment on the partnership assets attributable to the basis step-up in the deceased partner's interest in the partnership. Merely relying on §754 in this manner, however, is not optimal—it might result in only a marginal step-up after considering discounting of the decedent's partnership interest and the adjustment applies to every asset in the partnership, possibly resulting in a "step-down" in basis for some assets. The preferred approach is to make a liquidating distribution of the high basis asset to the older partner. The distribution results in the

older partner receiving the asset with a zero basis (assuming his outside basis in his partnership interest was zero). He will die with the zero-basis asset and get a full basis step-up, not impacted by discounting of the partnership interest. As long as a §754 election is in place, the stripped basis that was lost (when the high-basis asset was distributed, converting it into a zero basis asset) is moved to the low-basis asset remaining in the partnership for the benefit of the younger partners. (Paul Lee calls this "maximizing the free-base without having a taxable event.") The estate could contribute its high-basis asset (after the basis step-up at death) back into the partnership. There are no mixing bowl or disguised sales issues with this approach. Achieving this result involves a complex partnership tax structuring strategy.

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

> A partnership is owned by parent and two children, 1/3 each. The partnership has assets valued at $12 million. Assume there are no mixing bowl rules (i.e., assets were contributed more than 7 years ago, so that a distribution to one partner will not trigger a taxable event to another partner who contributed the distributed asset). Assume the "outside" basis in parent's partnership interest is zero. The partnership owns three assets, one of which has a built-in loss:
>
> Property 1: Basis $250,000, FMV $5M
>
> Property 2: Basis $250,000, FMV $5M
>
> Property 3: Basis $3M, FMV $2M (the built-in loss asset)
>
> If parent dies with this partnership structure, parent's partnership interest is worth $4M (assume no partnership discounts), and parent's outside basis is stepped up from zero to $4M. If a §754 election is in effect, this increases the inside basis of the two appreciated partnership assets, so:
>
> Property 1: Basis $2,250,000, FMV $5M
>
> Property 2: Basis $2,250,000, FMV $5M
>
> Property 3: Basis $3M, FMV $2M
>
> Alternatively, if the partnership had distributed the built-in loss assets (Property 3) to parent in a partial liquidation, parent would receive the $2M asset, which parent would receive with a basis of zero and parent's outside basis in the remaining partnership interest would be zero. §732(a). The partnership would be left with $10M of assets, and parent would own his remaining $2M value / $10M or 20%. Each child would own 40%. If the §754 election is in effect, the $3M of "stripped" basis in Property 3 is reallocated to the remaining partnership assets, so the inside basis and values of the partnership assts would be:
>
> Property 1: Basis $250,000 + $1.5M = 1.75M, FMV $5M
>
> Property 2: Basis $250,000 + $1.5M = 1.75M, FMV $5M
>
> At parent's death, Property 3 (owned by parent) would receive a basis step-up under §1014 to its FMV of $2M. Parent's outside basis in the partnership interest would be stepped-up to its FMV, or $2M. IF the §754 election is in effect, parent's $2M outside basis step-up further increases the basis in Property 1 and Property 2 by $1M each, so:
>
> Property 1: Basis $2.75M, FMV $5M
>
> Property 2: Basis $2.75M, FMV $5M
>
> In effect, this strategy has augmented the inside basis of the appreciated property (the appreciated assets would have had a basis of $2.25M each if the partial liquidating

distribution had not been made, as illustrated above; the effect is to allocate an additional $1M of basis to the appreciated assets).

7. BASIS ADJUSTMENT FLEXIBILITY PLANNING

Basis adjustment planning has taken on increased importance in light of the large $5 million indexed estate exemption. Many trust beneficiaries (or donors) will have estates less than the indexed exemption amount at the individual's death. Obtaining a basis step-up at the individual's death, rather than avoiding estate taxes, will be paramount. Various article address flexible planning alternatives. *E.g.*, Jonathan Blattmachr & Madeline Rivlin, *Searching for Basis in Estate Planning: Less Tax for Heirs*, 41 EST. PLANNING (August 2014); Mickey Davis, *Basis Adjustment Planning,* STATE BAR OF TEXAS 38TH ANN. ADV. EST PL. & PROBATE COURSE, ch. 10 (2014); Turney Berry, *Retaining, Obtaining, and Sustaining Basis*, ANNUAL NOTRE DAME TAX & EST. PL. INST., ch. 6 (2014).

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

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

- Repurchase from a grantor trust of appreciated assets for cash or other high basis property by the donor;
- Independent third party exercise of authority to grant the donor a testamentary limited power of appointment, which would cause estate inclusion under §§2036(a)(2) and 2038 and result in a basis adjustment under §1014(b)(9);
- Donor use of the property in some way that would reflect an implied agreement of retained enjoyment to cause estate inclusion under §2036 (such as using property without paying adequate rent);
- If the donor is a discretionary beneficiary of the trust, move the trust situs to a state that does not have domestic asset protection provisions; or
- Selling loss assets to a grantor trust to avoid a step-down in basis at the grantor's death (because the loss assets would not be owned by the grantor at death).

b. ***GST Impact.*** Basis adjustment planning considerations for trusts are important particularly for GST-exempt trusts. For non-exempt trusts, if a taxable termination occurs at a beneficiary's death (for example, when the last non-skip person dies), a GST tax is imposed and a basis adjustment is allowed as long as the taxable termination is occurring as a result of the death of an individual. §2654(a)(2).

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

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

Another possible way of addressing the potential reluctance of exercising broad distribution powers because of fiduciary concerns is to grant someone a non-fiduciary power of appointment to appoint trust assets to the surviving spouse. However, gift tax concerns with the exercise of such a power of appointment may arise if the powerholder is a beneficiary of the trust. *See* Treas. Reg. §§25.2514-1(b)(2), 25.2514-3(e) Ex.3; PLRs 9451049, 8535020.

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

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

The surviving spouse, with the approval of the trustee, transferred over $2 million of stock to a CRUT, which resulted in substantial estate tax savings at her death. After her death, the remainder beneficiaries of the marital trust sued the trustee and the spouse's estate planning attorney who assisted with the CRUT structuring. The court concluded that the language of the trust did not require the trustee to consider other financial resources of the spouse to provide for her own needs.

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

> "need or condition" of the corpus of the trust itself. Finally, we believe that the appellees adduced sufficient evidence below that the distribution from the principal of the marital trust was necessary in order to mitigate estate tax consequences upon the death of Mrs. Tierney.

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

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

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

If there are concerns as to how the power holder might exercise a general power of appointment, it might be limited to an appointment in favor of the power holder's creditors, or it might be exercisable only with the consent of a non-adverse party (that is still a general power of appointment, §2041(b)(1)(C)(ii)). To protect the third party from an argument that the party must continually monitor whether to grant or change powers of appointment, the trust could provide that the third party has no authority to grant a general power of appointment until requested by one of various specified family members to do so. In addition, in light of the fiduciary issues that could arise in granting such a general power of appointment, consider using an extremely broad exculpatory clause for the third party. (As Paul Lee puts it—"Why didn't you realize that giving a $9 million general power of appointment to my dad, notwithstanding the income tax savings, actually increased the value of the estate for purposes of determining the elective share? You actually caused $3 million to pass to the step-monster.")

The possibility of requiring the consent of a non-adverse party, which would still result in the power being a general power, also adds a concern. Section 2041(b)(1)(C)(ii) provides that a power exercisable "in conjunction with" a non-adverse party is still a general power of appointment. One commentator raises the question of whether there is a real difference between a power that is conferred by a third party vs. a power exercisable in conjunction with a third party. *See* Ronald Aucutt, *When is a Trust a Trust?,* at 17, Printed as part of *It Slices, It Dices, It Makes Julienne Fries: Cutting Edge Estate Planning Tools,* STATE BAR OF TX. 20th ANN. ADV. ESTATE PLANNING STRAATEGIES COURSE (2014). This raises the possible IRS argument that the beneficiary may be deemed to hold a general power of appointment even if it is never formally granted by the third party. A possible counterargument is the provision in Reg. §20.2041-3(b) that if a power is exercisable only on the occurrence of an event or contingency that did not in fact take place, it is not a general power of appointment. If the independent party never grants the general power of appointment, arguably that is a contingency that never took place within the meaning of that regulation.

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

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

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

Several private letter rulings have concluded that formula general powers of appointment equal to a beneficiary's remaining estate exclusion less the value of the beneficiary's other estate assets were effective in causing estate inclusion of the trust assets up to that amount. PLRs 200403094 ("having a value equal to

(i) the amount of my wife's remaining applicable exclusion amount less (ii) the value of my wife's taxable estate determined by excluding the amount of those assets subject to this power"); 200604028 ("equal to the amount of Husband's remaining applicable exclusion amount set forth in § 2010 of the Internal Revenue Code ('Code') minus the value of Husband's taxable estate (determined by excluding the amount of those assets subject to this power)"). Those rulings addressed other issues as well, but the rulings clearly reasoned that the assets were included in the deceased beneficiary's gross estate.

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

> By-Pass Trust - Spousal Testamentary General Power of Appointment.
>
> I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the By-Pass Trust. The fractional share and other terms applicable to the power are as follows:
>
> Fractional Share. The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate, will not result in or increase the federal estate tax payable by reason of my spouse's death. The denominator of the fraction shall be the value of the By-Pass Trust as of my spouse's death.
>
> How Exercised. My spouse may exercise the power by appointing the said fractional share free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment.
>
> [For the sake of brevity, the sample GPOA language provided herein does not include all of the form language needed to address other matters such as the permissible scope of a power of appointment granted to an object of the power, the allowable effect of an exercise on an S election, whether the last will and testament exercising the testamentary power of appointment must be probated, etc.]

(3) *Acts of Independent Significance.* If the surviving spouse (or other beneficiary) has the power to impact the amount that would be subject to the general power of appointment under the formula, the IRS might argue that the beneficiary has a general power of appointment to that maximum extent. *See Kurz v. Commissioner*, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995). In *Kurz*, the decedent was a beneficiary of both a marital trust and a family trust. The decedent was entitled to all income and the right to withdraw principal of the marital trust. She could request distributions from the family trust subject to two conditions: (1) the principal of the marital trust must have been exhausted; and (2) she could withdraw no more than 5% per year from the family trust. In fact, the decedent did not withdraw the entire principal from the marital trust, so could not withdraw any principal from the family trust at her death. However, the IRS argued that she had a general power of appointment over 5% of the family trust because the contingency to be able to exercise that power was within the decedent's control (*i.e.*, she could have withdrawn all of the principal from the marital trust so that contingency would have been satisfied). The estate argued that the decedent's access to the principal of the family trust was subject to a

contingency that did not occur, so she did not have a general power of appointment under Reg. §20.2041-3(b) ("However, a power which by its terms is exercisable only upon the occurrence during the decedent's lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent's death. For example, if a decedent was given a general power of appointment exercisable only after he reached a certain age, only if he survived another person, or only if he died without descendants, the power would not be in existence on the date of the decedent's death if the condition precedent to its exercise had not occurred."). The Tax Court interpreted this regulation to conclude that the decedent could have some control over the contingency and still not have a general power of appointment, but the contingency must not be "illusory" and must have independent significant non-tax consequences:

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

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

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

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

> By contrast, the sequence in which a beneficiary withdraws the principal of a series of trusts barely comes within the common understanding of "event or...contingency". No one could say of a single account: "You cannot withdraw the second dollar from this account until you have withdrawn the first." The existence of this sequence is tautological, but a check for $2 removes that sum without satisfying a contingency in ordinary, or legal, parlance…
>
> No matter how the second sentence of sec. 20.2041-3(b) should be applied to a contingency like losing 20 pounds or achieving a chess rating of 1600, the regulation does not permit the beneficiary of multiple trusts to exclude all but the first from the estate by the expedient of arranging the trusts in a sequence. No matter how long the sequence, the beneficiary exercises economic dominion over all funds that can be withdrawn at any given moment. The estate tax is a wealth tax, and dominion over property is wealth. Until her death, Ethel Kurz could have

withdrawn all of the Marital Trust and 5 percent of the Family Trust by notifying the Trustee of her wish to do so.

As an example of how this doctrine might apply in the context of formula general powers of appointment for basis optimization purposes, the power to make marital or charitable bequests is within the decedent's control, and if the formula refers to the maximum amount that could pass without estate tax at the decedent's death, the formula could be interpreted to assume that the decedent would leave all of his estate to a surviving spouse or charity and therefore give the decedent a general power of appointment over all of the trust (up to the decedent's exemption amount) even if the decedent in fact did not leave his estate to a surviving spouse or charity. The contingency to have a general power of appointment over the trust up to the maximum amount is within the decedent's control.

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

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

> the largest portion of the assets of the Bypass Trust which would not increase any federal estate tax payable by the estate of the Surviving Trustor without taking into consideration any charitable or marital gift by the Surviving Trustor that would be deductible by the estate of the Surviving Trustor pursuant to Section 2055 or Section 2056 of the Internal Revenue Code.
>
> *See* Al Golden, *Back to the Future – The Marital Deduction from Before ERTA to After ATRA*, STATE BAR OF TEXAS ADVANCED ESTATE PLANNING COURSE at p.17 (2013)(excerpt from formula general power of appointment form suggested by Mr. Golden).

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

> Making charitable or spousal bequests should logically be deemed to be acts of independent significance, such that they would not be deemed to control the grant of a general power of appointment, but it is not certain that a court would so hold, and it is very possible that the IRS would assert this position and the taxpayer would need to litigate.
>
> One could minimize this risk by drafting the formula clause granting a general power of appointment based on the surviving spouse's taxable estate, determined without regard to

> marital or charitable deductible transfers. This approach significantly reduces the likelihood that a court would conclude that the surviving spouse holds a general power of appointment over a greater share of the trust assets than his or her available applicable exclusion amount. If it is known that the surviving spouse will make certain charitable bequests, these can be expressly excluded from the calculation, with the same result.
>
> HOWARD ZARITSKY, PRACTICAL ESTATE PLANNING IN 2011 AND 2012.

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

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

f. ***Basis Step Up Flexibility; Delaware Tax Trap.***

(1) *Section 2041(a)(3).* Another alternative to leave the flexibility to cause inclusion in the beneficiary's estate is to use the "Delaware tax trap." Delaware law at one time (perhaps still) provided that if someone exercises a power of appointment to grant a presently exercisable power of appointment to another person, even a limited power of appointment, that grant of the new power is treated as a vesting of property for purposes of the rule against perpetuities. The original power could be exercised to appoint the assets in further trust, with a new perpetuities period running from the date of exercise, which means that the trust could be extended indefinitely without having the assets subjected to estate tax. Sections 2041(a)(3) and 2514(d) were enacted to prevent avoiding the estate tax indefinitely by successive exercises of limited powers of appointment and creating new powers in other persons of new presently exercisable limited powers of appointment. Section 2041(a)(3) provides that property subject to a non-general power of appointment (which would generally not cause inclusion under § 2041) will cause estate

inclusion under that section if the power holder exercises the power of appointment "by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power."

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

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

inclusion, the beneficiary would exercise the original power to create a presently exercisable general power of appointment in someone else. That would cause estate inclusion in the original power holder's gross estate under § 2041(a)(3).

In the context of planning for basis adjustment purposes, the power would be granted only over assets with significant appreciation and that are not income in respect of decedent assets (for which no basis adjustment is available). An example of a formula exercise of a special power of appointment to trigger the Delaware Tax Trap is attached as Appendix C, from an outstanding article by Mickey R. Davis, *Basis Adjustment Planning*, STATE BAR OF TEX. 38th ANN. ADV. EST. PLANNING & PROBATE COURSE, ch. 10 (2014).

A negative aspect of causing estate inclusion in that manner is that the assets would also have to be included in the successor power holder's gross estate as well (because the second power holder would hold a general power of appointment). A possible strategy that might avoid negative consequences of estate inclusion for the recipient of the power is if the power can be granted to a beneficiary whose estate is well below the exemption amount and for whom the estate inclusion will not likely be enough to impose estate taxation at the individual's death. For example, if the beneficiary's parent or parents have nominal assets, they may be possible appointees (assuming they survive the beneficiary). Other successor potential recipients of the power would be listed in case the parent did not survive the beneficiary.

Another possible negative aspect of exercising a special power of appointment to create a PEG power is that the assets subject to the PEG power may be reachable by the PEG powerholder's creditors. See subparagraph g below.

(3) *Exercising Special Power of Appointment to Create a Special Power of Appointment In Another Person IF That Begins a New RAP Period Under State Law (Example-Arizona)*. The common law rule is that for purposes of applying the rule against perpetuities, a power of appointment that is created by the exercise of another (the original) power of appointment is treated as having been created on the date that original power of appointment was created, so the RAP period does not change. An Arizona statute provides that a nongeneral power of appointment is valid only if one of several conditions is met, the primarily used condition being that the power is exercised or terminates within five hundred years "*after its creation*." ARS §14-2901.C.2. In addition, §14-2905.C gives the person exercising a power of appointment the ability to designate in the instrument exercising the power that the power of appointment is "*created*" when the power is exercised. These provisions apply to a nonvested property interest *or a power of appointment* that is created on or after December 31, 1994; hence, they apply to a person exercising a power of appointment to create a new power of appointment on or after December 31, 1994). Therefore, under Arizona law, the person who wants to trigger the Delaware Tax Trap can do so by exercising the special power to create another *special* power of appointment and designating in the exercise that the new power of appointment is created on the date the original power is exercised. This has several key advantages. (1) The

subsequent powerholder does not have a general power of appointment so the trust assets will not be included in the subsequent powerholder's gross estate for estate tax purposes. (2) The assets are protected from the beneficiary's control or unrestricted ability to exercise the power (which is the case if the beneficiary has a PEG power), (3) The assets are not subject to claims of the new powerholder's creditors. The Arizona statute and planning considerations with it are discussed at length in Les Raatz, *"Delaware Tax Trap" Opens Door to Higher Basis for Trust Assets*, EST. PLANNING (FEB. 2014).

(4) *Perhaps by Exercising Special Power of Appointment to Create a Special Power of Appointment In A New Trust.* Les Raatz (an attorney in Phoenix, Arizona) suggests a novel argument from triggering the Delaware Tax Trap. He points out that §2 of the Uniform Statutory Rule Against Perpetuities ("USRAP"), which has been adopted in a majority of states (but not in Texas), may provide a method to trigger the Delaware Tax Trap. Section 2(c) provides as follows:

> For purposes of this Act, a nonvested property interest or a power of appointment arising from a transfer of property to a previously funded trust or other existing property arrangement is created when the nonvested property interest or power of appointment in the original contribution was created.

For example, assume A creates Trust 1 granting B a special power of appointment, and that someone (whether A or B or someone else) later creates Trust 2 that grants C a special power of appointment. Assume that B exercises the special power of appointment in Trust 1 by appointing the assets to Trust 2. USRAP §2(c) says that C's power of appointment is created (for purposes of the RAP) when Trust 2 was created, not when Trust 1 was created.

The comments to the Uniform Act indicate that the purpose of this provision is precisely so that the trustee of the recipient trust (Trust 2 in the above example) will not have to keep track of various RAP periods that might otherwise apply if additions are made to the trust at various times.

There is no authority for whether this interpretation of USRAP §2 is correct in this context. If it is, almost any exercise of a special power of appointment to appoint assets into a new trust might trigger the Delaware Tax Trap in a USRAP state. To avoid an inadvertent exercise of the Delaware Tax Tap, the persons exercising the special power of appointment could provide that the RAP with respect to the appointed assets would continue to be based on the RAP that applied to the original trust.

(5) *States With Unlimited RAP; Applying a Years Limitation in the Original Trust and Providing That a Power Could Create a Trust That Would Last That Number of Years After the Date of Exercise of the Power.* Using the Delaware tax trap in states that have abolished their rule against perpetuities is more complicated. In that situation, a possible strategy suggested by some planners is to provide that the original trust lasts for 1,000 years, but that the power can be exercised to create a trust that could last for 1,000 years after the power is exercised. In this

manner, the vesting of the property could be postponed for a period "ascertainable without regard to the date of the creation of the first power." As an example, Steve Gorin (St. Louis, Missouri), suggests using the following clause in a state that has abolished its rule against perpetuities:

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

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

(6) *Caution Regarding Use of Delaware Tax Trap in This Context.* At the 2014 Heckerling Institute, one panelist cautioned that she would not want to rely on the "Delaware tax trap" to cause estate inclusion in the context of obtaining a basis increase because there have been no cases addressing the application of §2041(a)(3) in order to affirmatively cause estate inclusion.

g. ***Asset Protection Impact of Triggering Basis Adjustment.*** The mere existence of the structured flexibility for triggering estate inclusion does not of itself create creditor concerns. However, the actual exercise of the adjustment powers may in some cases subject assets to the beneficiary's creditors. If the assets are distributed to the beneficiary, obviously they can be reached by the beneficiary's creditors. If the beneficiary is granted a general power of appointment (either by a third party or by formula at the beneficiary's death), the general rule is that would not by itself allow creditors to reach the assets; however, the beneficiary's creditors could reach the assets if the beneficiary actually *exercised* the general power of appointment. That traditional rule was the position of the Restatement (Second) of Property (Donative Transfers) (§13.2, 13.4, 13.5). The Restatement (Third) of Property, however, takes the position that property subject to an *unexercised* general power of appointment can be reached by the power holder's creditors if his or her property or estate cannot satisfy all of the power holder's creditors. Restatement (Third) of Property (Donative Transfers) §22.3 (2011). Some states (such as California, Michigan and New York) have specific statutory measures adopting the position of the Third Restatement. The Uniform Trust Code applies the Restatement (Third) position to inter vivos general powers of withdrawal in §505(b)(1) (presumably that would also apply to general powers of

appointment); it does not address property subject to a testamentary general power of appointment, but refers to the Restatement *Second* position—suggesting that creditors could not reach property subject to an unexercised testamentary general power of appointment. A possible solution is to require the consent of a third person (who would need to be a nonadverse party in order for the power of appointment to cause estate inclusion under §2041). *See* Bove, *Using the Power of Appointment to Protect Assets—More Power Than You Ever Imagined,* 36 ACTEC L.J. 333, 337-38 (Fall 2010).

8. Planning Basis Adjustment Regardless Which Spouse Dies First; Joint Spousal Trusts (To Facilitate Funding Credit Shelter Trusts and for Basis Adjustment); Section 2038 Marital Trust

a. ***Community Property.*** The rationale of the basis step-up for both halves of community property goes back to 1948 when the marital deduction was instituted. The general thinking was that husbands would likely own all of the marital assets and husbands were likely to die first, so a full basis step-up would be available for all marital assets for most couples at the first spouse's death. If only the decedent's one-half of community property received a basis step-up, community property states would be disadvantaged compared to common law states. The rule for community property is now based on outdated assumptions, but it continues.

Spouses in community property states get a basis step-up on all community property regardless of which spouse dies first. Any separate property could be converted to community property (through a "transmutation agreement"). But a question arises as to whether that is a transfer that might trigger §1014(e) if the "recipient" spouse dies within one year.

For couples that do not live in community property states, the spouses might create community property by conveying assets to a "Community Property Trust" under Alaska or Tennessee law. See the discussion in Item 1.I of the ACTEC 2013 Fall Meeting Musings found here and available at www.bessemer.com/advisor.

Owning assets as community property vs. separate property has real life consequences, including (1) ownership and disposition on death or divorce, (2) management rights, and (3) what property is liable for debts of a spouse.

b. ***Joint Spousal Trusts-Significance.*** (1) Joint spousal trusts have been used as a strategy for assuring that the first decedent's spouse has sufficient assets in his or her gross estate to fully utilize the estate exclusion amount. This is not as important now that we have portability. (2) The joint trust has also been used in the hope that it would secure a basis step-up at the first spouse's death for all of the marital assets (mirroring what happens with community property). (3) As a practical matter, many couples view their assets as joint assets, and using a joint trust coincides with that perception (even if doing so may cause complexities later on).

c. ***Gross Estate Inclusion to Allow Full Funding of Credit Shelter Trust At First Spouse's Death.*** Several private letter rulings, and in particular PLR 200101021, provide that giving the first decedent-spouse a general power of appointment over all of the joint trust assets is workable to facilitate funding the credit shelter trust at the first spouse's

death. This is not as important now that portability is available to avoid wasting the first decedent-spouse's unused estate exclusion. For spouses that wish to fund a credit shelter trust at the first spouse's death, however, this planning can be very helpful to facilitate having sufficient assets to fund the trust even if the "non-propertied" spouse dies first.

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

The IRS ruled that (1) there was no completed gift on creation of joint trust, (2) all of the trust assets were included in the gross estate of the first decedent-spouse, (3) the assets passing to a credit shelter trust at the first spouse's death were not included in the surviving spouse's estate under §2036, and (4) there was a gift from the surviving spouse to the first decedent-spouse immediately before the moment of death, but the gift qualified for the gift tax marital deduction. (Some commentators have questioned whether this deemed gift and estate tax marital deduction ruling is correct, and some planners are uncomfortable using this technique without further clarification. The IRS is not attacking them, however.) These rulings and the reasoning of the IRS are discussed more fully in Item 9.e of the ACTEC 2013 Fall Musings found here and available at www.Bessemer.com/Advisor.

d. ***General Power of Appointment Over All Joint Trust Assets to Obtain Basis Step-Up on All Joint Trust Assets; Section 1014(e).*** Another goal of the joint spousal trust is to achieve the result that applies to community property—to obtain a basis step-up on all assets in the trust, regardless which spouse contributed assets to the trust and regardless which spouse dies first.

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

Environment, 39 REAL PROP. PROB. & TR. J. 275 (2004). In any event, the IRS position is clear that a basis adjustment is allowed only for the portion of the joint trust assets attributable to the first decedent-spouse's contributions to the trust, and most planners are not claiming the full basis step-up for all property in the joint trust in light of the IRS's position in these PLRs.

This planning strategy has been referred to as the "Joint Exempt Step-Up Trust (JEST). *See* Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 1,* 40 EST. PLAN. 3 (Oct. 2013); Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 2,* 40 EST. PLAN. _ (Nov. 2013). The authors suggest that the assets passing from the share of the surviving spouse on the death of the first dying spouse based upon the power of appointment exercisable by the first dying spouse should go into a separate trust of which the surviving spouse may not be a beneficiary (or only addable as a beneficiary by independent Trust Protectors), or which may be less likely to provide benefits to the surviving spouse based upon restrictive language or the need to receive consent from an adverse party. The authors note that this should provide a higher probability of success for receiving a stepped-up income tax basis if the Service were to challenge this. The authors also note that the separate credit shelter trust funded from the assets coming from the share of the surviving spouse will be considered as an incomplete gift by said spouse if the IRS can show that the surviving spouse was the actual contributor, since he or she has retained a testamentary power of appointment. The authors also point out that the credit shelter trust funded from the assets owned by the surviving spouse might be considered to be a gift by said spouse, and that said spouse could disclaim the testamentary power of appointment described above so that the gift would not be incomplete. Further, the surviving spouse may be given the power to replace trust assets with assets of equal value so that the intended second credit shelter trust would instead be operated as a defective grantor trust. The authors report that a number of planners have indicated that they are using this system, and expect to consult carefully with the surviving spouse and family after the first death in order to determine how to proceed with this flexible design trust system.

Whether the assets pass to a QTIP trust or a credit shelter trust for the surviving spouse, arguably §1014(e) would not apply on the theory that the asset did not pass back to the donor for purposes of this income tax statute but into a trust for the benefit of the donor (even if the assets pass to a QTIP trust that is included in the surviving spouse's gross estate for estate tax purposes). Letter Ruling 9026036 (reversed as to other issues and reissued as PLR 9321050) may provide some support for this argument. Letter Ruling 9026036 addressed a situation in which property transferred by a wife to a QTIP trust for her husband would return to a QTIPable trust for wife if husband predeceased her. The IRS ruled that only the portion of the trust allocable to the life income interest would be affected by §1014(e), and the remainder interest would not be deemed to pass back to the donor spouse and thus would qualify for a basis step-up.

The legislative history to §1014(e), which was passed in 1981 as a part of ERTA, discusses that §1014(e) applies if the property passes to the donor directly or

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(ii) the individual's NII for the year.

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

(i) the estate's or trust's adjusted gross income (as defined in §67(e)) in excess of the highest income tax bracket threshold ($11,950 for 2013, $12,150 for 2014, $12,300 projected for 2015), or

(ii) the estate's or trust's undistributed net investment income.

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

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

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

   Some types of income, however, escape the 3.8% tax totally. For example, executor fees paid to an individual fiduciary may escape the wage, self-employment and net investment income tax. *See* New York State Bar Association Tax Section Report on the Proposed Regulations Under Section 1411, Report 1284, May 15, 2013.

c. ***Regulations Overview.*** Proposed regulations were published on December 5, 2012 (with corrections on January 31, 2013). The IRS received numerous comments and released final regulations on November 26, 2013 (scheduled for official publication on December 2, 2013). In addition, the IRS released a new set of proposed regulations regarding various topics that are not covered in the final regulations. Among other issues in the final regulations:

- No “fresh start” for making the election to consistently treat distributions as including realized capital gains is permitted (in order to satisfy one of the methods of including capital gains in DNI);
- There is no guidance regarding how a trust or estate “materially participates” in a trade or business, but the IRS is studying the issue and has sought comments as to whether it should give additional guidance regarding that topic for purposes of §469 as well as §1411;
- Under the final regulations, charitable remainder trusts (“CRTs”) must track net investment income within each class of the trust’s income to determine the amount of undistributed net investment income, but the newly proposed regulations still permit CRTs to use the “simplified method” of tracking net investment income as described in the December 2012 proposed regulations (with a few modifications);
- New proposed regulations provide additional detail regarding the determination of the amount of net investment income arising as a result of dispositions of certain interests in partnerships of S corporations; and
- New proposed regulations take the position that if a QSST sells its S stock, the determination of whether or not there is material participation in the S corporation’s business (so that the resulting gain would qualify for the non-passive trade or business income exception) is made at the trust level, and not based on the activity of the trust beneficiary (even though the trust beneficiary is generally treated as the §678 owner with respect to S corporation stock held by a QSST. Some professional groups will be filing comments with the IRS urging a revision of the proposed regulation so that the material participation would be determined at the beneficiary level in that circumstance).

d. ***Grantor Trusts.*** The §1411 tax is not imposed on grantor trusts, but items of income, deduction or credit are treated as if they had been received or paid directly by the grantor for purposes of calculating that person’s individual net investment income. Reg. §1.1411-3(b)(1)(v). The net investment income from the trust is treated as owned by the grantor, and will be taxed based on the grantor’s individual threshold ($250,000/$200,000)). Material participation (for purposes of the active business income exception, discussed below) is tested based on participation by the grantor. See General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, at 242, n.33. Spousal attribution of material participation, allowed generally under §469(h)(5), should be applicable.

e. ***Net Investment Income.*** There are three major categories of income, which are offset by various allowed deductions, to determine NII. A common theme of all three categories is that if an item of income is not treated as income for regular tax purposes, it will not be NII for surtax purposes. The income items are--

- Category 1. Gross income from interest, dividends, annuities, royalties, and rent (but not including those items that are income derived in the ordinary course of a non-passive business [such as rents, discussed below]). Any of

these items that are not in regular income are not in NII—for example, municipal bond interest income is not included in NII.

- Rents are generally passive for purposes of the §1411 tax. There is an exception for real estate professionals that devote 500 hours annually to working in the real estate business. Reg. § 1.1411-4(g)(7). Otherwise, taxpayers must meet two tests for rent to be excepted from being net investment income: (i) material participation and (ii) the rental income activity is a trade or business.
- Category 2. Gross income that is from (1) a passive activity or (2) a trade or business of trading in financial instruments or commodities is NII. (Rents would generally be considered passive income, but they are included in Category 1.) To determine whether an activity is "passive," the passive activity loss rules of §469 apply. This category includes business income if the taxpayer does not materially participate in the business. Passive loss carryovers apply for NII purposes to offset passive NII (even passive loss carryover from years prior to 2013 can offset passive NII income).
  - Under the § 469 passive loss rules, activities may be "grouped"; an individual's activities in several businesses that are grouped may rise to the level of being material participation, even though the individual would not meet the material participation standard for any separate activity. Regrouping is generally not permitted under § 469, but a one-time regrouping is allowed (which will apply for both regular and surtax purposes) on the return for the first year the individual would be subject to the surtax. Reg. §1.469-11(b)(3)(iv).
  - Working interests in oil and gas property are treated as active, not passive activities. This applies whether the taxpayer owns the working interest directly or in an entity—except that if the interest is owned in an entity that limits the liability of the taxpayer, the interest will be deemed to be a passive activity. §469(c)(3)(A).
- Category 3. Net gain that is included in taxable income (this would include capital gains). Examples of gains that are not included in taxable income (and therefore are not NII) include gain that is excluded from gross income on the sale of a principal residence, Qualified Small Business Stock, ESOP stock, build-up in value of life insurance policies, and tax-free like-kind exchanges and tax-free exchanges of life insurance policies. Gain on the sale of business assets used in an active business is not included in NII. Gains attributable to goodwill in the sale of an active business's are not NII. (The 2012 proposed regulations include this statement about goodwill, Prop. Reg. § 1.1411-7(c)(5)(ii)(B); the final regulations do not specifically address goodwill;) Net gain includes "recapture" income that is often recognized on the sale of investment real estate. Reg. § 1.1411-4(d), Ex. 2. Capital losses can offset

gains (indeed, "net gain" is what is included as NII in Category 3), but capital losses can offset income in Categories 1 or 2 only up to $3,000 per year.

- Gain from the sale of S corporation or partnership interests is subject to special rules designed to be taxpayer friendly. The seller can exclude from NII the amount of gain that would have been excluded from NII (*i.e.*, the gain attributable to active trade or business assets) if the entity had sold its assets immediately before the taxpayer's sale of its interest in the entity. §1411(c)(4). The 2012 proposed regulations had a complicated 4-step process, but the final regulations withdrew the 2012 prior regulations and new proposed regulations were issued adopting commentators' suggestions to simplify the reporting process. Prop. Reg. §1.
1411-7.
- Excluded Income Items. Several types of income are specifically excluded from NII, including (i) distributions from IRAs and qualified plans, (ii) non-passive trade or business income, (iii) tax-exempt income and tax-exempt annuities, and (iv) income subject to self-employment tax. As discussed above, certain gains from the disposition of interests in partnerships and S corporations are excluded. The final regulations specifically address various other exclusions covered by non-recognition provisions (such as §1031), income covered by various exclusion provisions (such as §§ 103 or 121), wages, compensation, unemployment compensation, Social Security benefits, and alimony.

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

f. ***Exception for Non-Passive Business Income; Material Participation***. The non-passive trade or business income exception requires that (1) there be an activity that involves a trade or business (within the meaning of §162) and (2) is a non-passive activity within the meaning of §469, which requires material participation by the taxpayer. Reg. §1.1411-5(a-b). (There is no exception for business income from trading financial instruments or commodities, whether or not the activity is passive.) Thus, generally there must be *both* (1) a trade or business and (2) material participation by the taxpayer. As an example, if real estate that is used in a business is held in a separate entity from the operating company, such rental income will not be trade or business income (unless the real estate company is in the trade or business of leasing multiple similar real properties). Also, generally any interest, dividends, capital gains, etc. earned on investment assets held by the business will constitute NII, no matter how strong the business purpose is for holding the investment assets and no matter if there is material participation so that the business is an active activity. Reg. §1.1411-6.

The material participation requirements under the §469 passive loss rules are used for determining whether an activity is passive for purposes of the exception from the

surtax for business income. §1411(c)(2)(A). Section 469(h)(1) defines material participation as an activity in which the taxpayer participates on a "regular, continuous, and substantial basis."

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

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

> (b) Passive activity--(1) In general. A passive activity is described in this section if
>
> (i) such activity is a trade or business; and
>
> (ii) Such trade or business is a passive activity with respect to the taxpayer within the meaning of section 469 and the regulations thereunder.
>
> (2) Application of income recharacterization rules--(i) Income and gain recharacterization. To the extent that any income or gain from a trade or business is recharacterized as "not from a passive activity" by reason of §1.469-2T(f)(2), §1.469-2(f)(5), or §1.469-2(f)(6), such trade or business does not constitute a passive activity within the meaning of paragraph (b)(1)(ii) of this section solely with respect to such recharacterized income or gain. Reg. §1.1411-5(b)(2)(i).

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

Although income from a trade or business may be recharacterized as "not from a passive activity" (as described above), the §1411 regulations have an exception if the

income is further recharacterized as "portfolio income" under certain §469 regulations (that further cross reference to other §469 regulations):

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

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

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

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

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

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

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

g. ***Material Participation by Trusts or Estates.*** There is no guidance regarding how a trust or estate "materially participates" in a trade or business, under either the §469 or §1411 regulations. The §1411 final regulations declined to provide any guidance regarding this issue, despite the fact that it is now of much greater importance than for just the passive activity loss rules. The Preamble to the final regulations points out that "the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance

project issued under section 469 at a later date." The IRS requested comments, including "recommendations on the scope of any such guidance and on specific approaches to the issue." The Treasury Priority Guidance Plan for 2014-2015 issued August 26, 2014 includes the following new item: "Guidance regarding material participation by trusts and estates for purposes of §469." There are informal indications that this "guidance" will be proposed regulations.

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

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

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

(2) *Activities of Non-Trustee Agents of Trust Constituted Trust Material Participation, Mattie K. Carter Trust v. U.S.* A 2003 federal district court was the first to address in a reported case what activities can qualify as material participation under the passive loss rules for trusts and estates. *The Mattie K. Carter Trust v. U.S.*, 256 F. Supp.2d 536 (N.D. Tex. 2003). In the *Carter Trust* case, the trust operated active ranch operations, and the trustee hired a ranch manager (who was not a trustee). The IRS maintained that was not material participation for the trust because the trustee individually did not materially participate. The taxpayer maintained that, analogous to a closely held C corporation (see footnote 3 of the opinion), it could only participate in an activity through its fiduciaries, agents, and employees and that the activities of employees and agents of the trust should be included. The District Court sided with the taxpayer, concluding that material participation should be determined by reference to all persons who conducted the business on the trust's behalf, including employees as well as the trustee. Participation is tested by the activities of the trust itself, which necessarily entails an assessment of the activities of those who labor on the ranch, or otherwise in furtherance of the ranch business, on behalf of the trust. Section 469 states that "a taxpayer" is treated as materially participating in a business if "its" activities in pursuit of that business are regular, continuous, and substantial. §469(h)(1). The court reasoned that measuring the trust's participation by reference only to the trustee "finds no support within the plain meaning of the

statute. Such a contention is arbitrary, subverts common sense, and attempts to create ambiguity where there is none." The court observed that no regulations are on point, but "the absence of regulations and case law does not manufacture statutory ambiguity." The court acknowledged that it had studied the "snippet of legislative history IRS supplied" (including the Senate Finance Committee Report) as well as a footnote in the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986, at 242 n.33, but the opinion concludes that "the court only resorts to legislative history where the statutory language is unclear, … which, … is not the case here."

Aragona Trust (discussed below) in footnote 15 said that it was not faced with and did not address whether activities by non-trustee employees are considered in determining a trust's material participation.

(3) *Technical Advice Memorandum 200733023; Rejection of Carter Trust Reasoning, Treatment of Special Trustee.* The IRS disagreed with *Carter Trust* in Technical Advice Memorandum 200733023, concluding that notwithstanding the *Carter Trust* decision, the sole means for a trust to establish material participation is by its fiduciaries being involved in the operations, relying primarily on the legislative history that made specific reference to "an executor or fiduciary, in his capacity as such" clause. The ruling also reasoned that because a business will generally involve employees or agents, a contrary approach would result in a trust invariably being treated as materially participating in the trade or business activity, rendering the requirements of §469(h)(1) superfluous.

TAM 200733023 also addresses the effect of having Special Trustees with responsibility for the business. The ruling concluded under the facts of that situation, the Special Trustees were not fiduciaries for purposes of §469, because they gave recommendations but they were not able to commit the trust to any course of action or control trust property without the Trustees' express consent. The Trustees retained final decision-making authority over all facets of the business. The ruling reasoned that if advisors, consultants, or general employees could be classified as fiduciaries simply by labeling them so, the §469 material participation requirement for trustees would be meaningless. Furthermore, the ruling concluded that even if the Special Trustees were considered fiduciaries, many of their activities would not count in determining the trust's involvement in the business, because time spent negotiating the sale of the trust's interest in the company and resolving a tax dispute with another partner was not time spent managing or operating the business.

(4) *PLR 201029014; No Strict Application of "In Such Capacity" Clause in Legislative History.* Private Letter Ruling 201029014 reiterates the general IRS position that a trust materially participates in business activities only if the trustee is involved in the operations of the entity's activities on a regular, continuous, and substantial basis. It did not mention the *Carter Trust* case, but it cited the Senate Report's "in such capacity" language. The issue was whether a trust could materially participate in the business of a subsidiary (Sub 2) of a subsidiary (Sub 1) owned by a partnership in which the trust owned an interest. In light of the

trust's remote relationship with Sub 2, a strict application of the "in such capacity" clause in the legislative history would seemingly have prevented the trustee from being able to materially participate, because any actions of the trustee in the business of Sub 2 would have been taken in some capacity other than as trustee. In PLR 201029014, the IRS did not apply this strict approach, but agreed with the taxpayer that the trustee could materially participate in Sub 2 through the trustee's regular, continuous and substantial involvement in the operations of Sub 2.

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

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

cannot be considered to determine the trust's material participation in the business.

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

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

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

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

(8) *Character is Determined At Trust Level.* The final regulations say that the character of an item of trust income as NII (or not) is determined at the trust level (for trusts that are not deemed to be owned by the grantor or a third party for income tax purposes under the grantor trust rules including §678), and that determination does not change when the income item is distributed to a beneficiary. Reg. §1.1411-3(e)(3)(ii). Accordingly, even if a beneficiary is clearly materially participating in a business, a distribution of business income from the trust to the beneficiary will not qualify for the "active business income" exception if the trust did not materially participate in the business to qualify for the exception at the trust level (and how a trust materially participates is subject to great uncertainty).(9) *Outstanding Resources.* For a detailed discussion of the application of the non-passive trade or business income exception from the §1411 tax to trusts, see Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1,* TAX NOTES 683, at 688-700 (Aug. 12, 2013) and Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 2,* TAX NOTES 785 (Aug. 19, 2013). Another excellent resource including planning strategies with respect to the trust material participation issue is Steve Gorin, *Structuring Ownership of Privately-Owned Business: Tax and Estate Planning Implications* (2014) (a 500+ page article addressing a variety of tax and estate

planning issues for businesses available from the author at sgorin@thompsoncoburn.com).

h. ***Material Participation by Trustee Recognized in* Frank Aragona Trust v. Commissioner***.*

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

Synopsis. The Frank Aragona Trust qualified for the "real estate professional exception" under §469(c)(7) so that rental losses were not disallowed as passive activities for purposes of the passive activity loss rules of §469. The IRS raised and the court addressed two major issues. First, the court rejected the IRS's contention that a trust can never qualify for the real estate professional exception even though the regulations refer to personal services "performed by an individual." The court concluded that if the trustees are individuals, their work can be considered "work performed by an individual" and that a trust is capable of performing personal services and therefore can satisfy the §469(c)(7) exception.

Second, the court ruled that the trust materially participated in the real estate business, which is one of the requirements to satisfy the §469(c)(7) real estate professional exception. Three of the six co-trustees were full time employees of an LLC that managed the rental properties. The court concluded that the activities of the trustees, including their activities as employees of the LLC, are considered in determining material participation. The court reasoned that their activities as employees counted because (1) Michigan statutory law requires trustees to administer the trust solely in the interests of the beneficiaries, and (2) a Michigan case makes clear that trustees are not relieved of their duties of loyalty by conducting activities thorough a separate entity controlled by the trust. Also, the court rejected the IRS argument that two of the co-trustees owned minority interests in some of the entities that conducted the rental operations and that some of their activities were attributable to their personal portions of the businesses.
The court gave several reasons, including that their interests as individual owners were generally compatible with the trust's goals for the jointly held enterprises to succeed. *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (March 27, 2014) (Judge Morrison).

Basic Facts. The Frank Aragona Trust owned real estate rental properties and also owned interests in wholly owned entities and owned majority interests in other entities that conducted rental real estate activities. (It also owned majority and minority interests in entities that conducted real estate holding and development activities. Those entities that held and developed real estate were not involved in the issues in this case.)

The trust benefitted the grantor's five children, who shared equally in the trust income.

The grantor was the initial trustee. Following his death, there were six co-trustees-- his five children and one independent person as co-trustees. One of the children served as the "executive trustee" and "the trustees formally delegated their powers to the executive trustee (in order to facilitate daily business operations), "but the trustees acted as a management board for the trust and made all major decisions regarding the trust's property."

Three of the children were full time employees of an LLC that operated the properties.

The LLC that managed the properties was wholly owned by the trust (and was treated as a disregarded entity for income tax purposes). The LLC employed "several people" in addition to the three children, "including a controller, leasing agents, maintenance workers, accounts payable clerks, and accounts receivable clerks."

The 5 children were paid $72,000 per year as a trustee fee. Those with limited involvement in the business were paid the same trustee fee as those who were full time employees of the LLC. The independent trustee (an attorney) was paid $14,400 per year.

The trust claimed losses from the rental operations in 2005 and 2006, which contributed to net operating losses that the trust carried back to its 2003 and 2004 years. The issue is whether those rental losses are deductible or whether they should be treated as passive activity losses that are not currently deductible.

Holdings.

(1) A trust can qualify for the "real estate professional" exception under §469(c)(7) so that rental losses are not disallowed as passive activities for purposes of the passive activity loss rules of §469. If the trustees are individuals, their work can be considered "work performed by an individual" (as required by a regulation), so a trust is capable of performing personal services and therefore can satisfy the §469(c)(7) exception.

(2) The trust materially participated in the real estate business, which is one of the requirements to satisfy the §469(c)(7) real estate professional exception. The activities of three of the co-trustees as employees were considered in determining whether the trust materially participated in the business. Activities by two- co-trustees who also owned minority interests in some of the rental entities were not apportioned between the trust and their personal portions of the businesses.

Analysis.

(1) *Rental Losses Are Passive Unless the Real Estate Professional Exception Applies.* Any rental activity is considered a passive activity, §469(c)(2), unless what has been termed the "real estate professional exception" under §469(c)(7) applies.

The exception in §469(c)(7) has two tests. First, more than one-half of the "personal services" performed in trades or businesses by the taxpayer during the taxable year are performed in real property businesses in which the taxpayer materially participates. §469(c)(7)(B)(i). Second, the taxpayer must perform more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. §469(c)(7)(B)(ii).

[Observe that both of these tests requires material participation by the taxpayer, just to meet the real estate professional exception, aside from the general material participation requirement under §469(c)(1)(B). But presumably the same standards would apply for the general material participation requirement as for the material participation requirement that is part of the real estate professional exception.]

(2) *Trusts Can Satisfy the Real Estate Professional Exception.* The IRS argued that a trust can never meet the real estate professional exception. [This is consistent with the IRS's position in CCA 201244017.] The regulations describe "personal services" as that term is used in the first of the two tests for the real estate professional exception as meaning "any work performed by an individual in connection with a trade or business." Reg. §1.469-9(b)(4). The IRS argues that, based on its regulations, a trust is not an individual so cannot possibly meet the requirements of the real estate professional exception. The court rejects this argument. While comments in the House Report and Conference Committee Report for §469(c)(7) state that the provision applies to "individuals and closely held C corporations," the Reports do not say that the exception applies only to individuals and closely held C corporations. Congress could have excluded trusts if had meant to do so; other exceptions in the passive loss rules apply only to "any natural person," but the §469(c)(7) exception does not have that limitation.

The court reasoned that if the trustees are individuals, they can meet this regulatory requirement:

> If the trustees are individuals, and they work on a trade or business as part of their trustee duties, their work can be considered "work performed by an individual in connection with a trade or business." Sec. 1.469-9(b)(4), Income Tax Regs. We conclude that a trust is capable of performing personal services and therefore can satisfy the section 469(c)(7) exception.

(3) *Little Authority Regarding Material Participation by Trust.* Section 469(h) states that material participation requires "regular, continuous, and substantial" involvement in the operations of the business. Regulations address how individuals or corporations meet the material participation requirement, but there is no statute or regulation addressing how a trust materially participates. There is one line in the legislative history about trust material participation. S. Rept. No 99-313, at 735 (1986), 1986-3 C.B. 1, 735 states that a trust "is treated as materially participating in an activity … if an executor or fiduciary, in his capacity as such, is so participating."

(4) *Activities of Non-Trustee Employees.* One case has addressed material participation by a trust. It held that the activities of non-trustee employees can be considered in determining whether a trust materially participated in a ranching activity. *Mattie K. Carter Trust v. United States,* 256 F. Supp. 2d 536 (N.D. Tex. 2003).

The *Aragona* court specifically noted that it was not faced with deciding whether the activities of non-trustee agents or employees should be disregarded. (Footnote 15).

(5) *Activities of Trustees as Employees Are Counted.* The IRS argued that the activities of the three co-trustees as full-time employees of the LLC should not be considered because (1) they performed their activities as employees, and (2) it is impossible to disaggregate the activities they performed as employees and as trustees. [This is consistent with the IRS's reasoning in TAM 201317010.]

The court concluded that the activities of the trustees, including their activities as employees, should be considered in determining whether the trust materially participated in real-estate operations. The court reasoned that state law requires trustees to look out solely for the interests of trust beneficiaries, and that trustees are not relieved of their duties of loyalty by conducting activities through an entity controlled by the trust.

> The trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary. Mich. Comp. Laws sec. 700.7302 (2001) (before amendment by 2009 Mich. Pub. Acts No. 46); see also In re Estate of Butterfield, 341 N.W.2d 453, 459 (Mich. 1983) (construing Mich. Comp. Laws sec. 700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws sec. 700.7302).
>
> Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. Cf. In re Estate of Butterfield, 341 N.W.2d at 457 ("Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy.") Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.

(6) *Activities of Trustees Who Also Co-Own Interests in the Business Are Counted.* The IRS argued that some trustees owned minority interests in some of the real estate activities and some of their activities were attributable to their personal portions of the businesses. Despite the individual minority ownership interests of two co-trustees, the trust materially participated. The court gave four reasons for considering the activities of the co-trustees who co-owned minority interests in the same business entities. (1) Their combined interests were not a majority interest. (2) Their combined interest was never more than the trust's interest in the entities. (3) Their interests as owners were compatible with the trust's goals for the success of the joint enterprise. (4) They were involved in managing day-to-day operations of the businesses.

(7) *Multiple Fiduciaries.* If there are multiple fiduciaries, how many of them must be involved in the business in order for the trust to materially participate? [Technical Advice Memorandum 200733023 provides that merely labeling a person involved in the business as a "special trustee" will not suffice. The determining factor is whether the special trustee had powers that could be exercised solely without the

approval of another trustee. If so, material participation of the special trustee would suffice. This raises concern of whether a majority of the multiple fiduciaries must be involved in the business.] The *Aragona* court did not address how to determine material participation by a trust that has multiple trustees. However, in *Aragona*, three of the six co-trustees (*not* a majority) were full-time employees of the LLC that operated the real estate business. Therefore, *Aragona* suggests that having a majority of co-trustees involved in the business is not required in order for the trust to materially participate.

Observations.

(1) *Case of Huge Importance; Increasing Significance Because of 3.8% Tax on Net Investment Income.* There has been only one other case (*Carter Trust*, a federal district court case) addressing how a trust materially participates in a business. This is the first case exhibiting how the Tax Court will address the issue—and it is a "regular" Tax Court case, not just a memorandum opinion.

The issue in *Aragona Trust* was whether the trust could deduct business losses under §469. Whether a trust materially participates in a business is increasingly important because non-passive business income is not subject to the 3.8% tax on net investment income (NII). The issue has far more importance than when the only issue was the ability to deduct losses under §469. Many trusts own interests in businesses that result in hundreds of thousands if not millions of dollars of business income per year. Whether that trust income is subject to the additional 3.8% tax can be quite significant. Furthermore, Richard Dees (Chicago) points out that the regulations under §1411 take the position that the characterization of trust income as NII is made at the trust level, and distributing income to a beneficiary who is actively involved in a business does not convert the income from being NII at the trust level to being non-NII at the beneficiary level. Reg. §1.1411-3(e)(3)(ii). (For grantor trusts, the participation in the business of the grantor deemed-owner of the trust is determinative.)

(2) *"Regular" Tax Court Opinion.* This is a "regular" Tax Court opinion, not a memorandum opinion of one judge. Taxpayers faced with similar situations know they can challenge the IRS in the Tax Court, rather than in a district court, and know the Tax Court's position.

(3) *Possibility of IRS Guidance Project.* There is little guidance regarding how a trust or estate "materially participates" in a trade or business, under either the §469 or §1411 regulations. The §1411 final regulations declined to provide any guidance regarding this issue, despite the fact that it is now of much greater importance than for just the passive activity loss rules. The Preamble to the final regulations points out that "the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date." The IRS requested comments, including "recommendations on the scope of any such guidance and on specific approaches to the issue."

While *Aragona Trust* provides very important viewpoints of the Tax Court, various issues remain for which the IRS could provide helpful guidance (for example,

whether material participation by a decedent would be "tacked" to the estate or perhaps to a testamentary trust for some period of time).

(4) *Overview of IRS Growing Attacks on Trust Material Participation.* Regulations addressing passive activity rules for trusts and estates have never been written. The IRS position is that the trustee must be involved directly in the operations of the business on a "regular, continuous, and substantial" basis. The IRS points to the legislative history of §469, which states very simply:

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

The IRS lost the only prior reported case that has addressed material participation by trusts. (The *Mattie K. Carter Trust* case is discussed below.) Since then, the IRS has issued several informal ruling positions, generally taking a strict approach toward trust material participation.

TAM 200733023 disagreed with the *Carter Trust* decision and said that activities of "Special Trustees" would not be considered in determining the trust's material participation if they did not have the authority to commit the trust to any course of action without approval of the trustees.

Letter Ruling 201029014 was taxpayer friendly in recognizing that a trust could materially participate in the activities of a multi-tiered subsidiary through the activities of its trustee even though the trustee had no direct authority to act with respect to the business in its capacity as trustee (because of the remote relationship of the trust to the subsidiary).

Technical Advice Memorandum 201317010 takes a very hard-nosed approach, refusing to recognize the activities of a co-trustee who was also the president of a subsidiary of an S corporation in which the trust owned an interest, reasoning in part that the activities were largely in the individual's capacity as employee and not as trustee. The *Aragona Trust* case in particular seems to undermine the IRS's strict approach in that TAM.

This prior case and these prior rulings are discussed in more detail above. Query whether, following its loss in *Aragona Trust,* the IRS will change its harsh attacks on seemingly every effort by a trust to materially participate in a business.

(5) *Specific Facts of Aragona Trust Involved Wholly Owned Management Entity.* The court's reasoning in *Aragona Trust* was related to the specific facts of the case. The court reasoned that state law requires trustees to look out solely for the interests of trust beneficiaries, and that trustees are not relieved of their duties of loyalty by conducting activities through an entity wholly owned by the trust (citing *In re Estate of Butterfield*, which refers to trustees who are directors of a corporation controlled by the trust). The court's reasoning is understandable in light of the fact that it specifically addressed the fact scenario presented by the Aragona Trust. The court gave no indication that it would necessarily limit its reasoning to that situation. Indeed, the first rationale (that the trustee must look out solely for the interests of trust beneficiaries) seems to acknowledge that any

activities of a trustee must be consistent with the trustee's duties to the beneficiaries.

(6) *Can Trustee Ever "Take Off Its Hat" As Trustee?* Some commentators have described this issue in terms of whether a trustee can ever "take off its hat" as a fiduciary. Under this approach, all activities of a trustee should be considered in determining material participation by the trust.

> A review of the existing tax guidance supports considering all of a trustee's actions in a trust-owned business in whatever capacity the trustee acts in determining whether the trust materially participates. The non-tax authorities support this conclusion too: the trustee is unable to completely remove her trustee "hat" when donning a different "hat" in a different capacity in the business. Where a trustee also acts in a potentially managerial role (e.g., for an entity the equity interests of which are trust assets), the trustee's fiduciary duties extend to her managerial activities. A trustee cannot disregard her fiduciary obligations to the beneficiaries when acting in another capacity, for example, as an employee or director, in a business owned by the trust. Because the trust will be a shareholder, the fiduciary duties a trustee owes the beneficiaries will not conflict with the fiduciary duties a director owes the shareholders. If they do, however, the director/trustee will have to recuse herself. Thus, all of the actions undertaken by an individual trustee with respect to any activity owned directly or indirectly by the trust are subject to her fiduciary obligations to the trust beneficiaries and, therefore, relevant to determine whether the trust materially participates under Code sections 469 and 1411. Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1,* TAX NOTES 683, at 688-700 (Aug. 12, 2013) (Question 10) and Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 2,* TAX NOTES 785 (Aug. 19, 2013).

In support of his analysis, Mr. Dees cites (and quotes) the Restatement (Third) of Trusts §78 & §86 cmt. e, Bogert on Trusts and Trustees §543 (Dec. 2012), and *In re Schulman,* 165 A.D.2d 499, 502 (N.Y. App. Div. 3d Dep't 1991) (citing various other New York cases).

(7) *Rejection of IRS Positon in TAM 201317010*. *Aragona Trust* goes a long way toward rejecting the IRS's strict position in TAM 201317010. The IRS's arguments in *Aragona Trust* were very similar to its reasoning in TAM 201317010 for not considering the activities by the LLC employees/trustees in the business operations:

> [The IRS] reasons that the activities of these three trustees should be considered the activities of employees and not fiduciaries because (1) the trustees performed their activities as employees of Holiday Enterprises, LLC, and (2) it is impossible to disaggregate the activities they performed as employees of Holiday Enterprises, LLC, and the activities they performed as trustees.

The court's rejection of the IRS's position direct rejection of this reasoning calls into question the basic tenets of the TAM. Furthermore, the court rejected the same type of reasoning with respect to its refusal to consider separately the activities attributable to the trust portion and the individual portion of the business by the trustees who also owned personal interests in the business.

Query whether the distinction of serving as employee of the wholly owned LLC in *Aragona Trust* vs. serving as employee of the corporation in the TAM is significant?

(8) *Multiple Trustees.* There is no guidance regarding what activities of multiple co-trustees are needed to satisfy the material participation requirement. Must all co-trustees materially participate? A majority? Any one co-trustee? *Aragona Trust* does not address this issue expressly, but on the facts of the case, material participation by each of three out of six co-trustees (not a majority) was sufficient. At a minimum this suggests that material participation by a majority of co-trustees is not required.

Can the activities of the co-trustees be aggregated? For example, if the 500 hour test that applies to individuals is applied to the activities of trustees, would the trust materially participate if the co-trustees in the aggregate devoted 500 hours to the business? This issue was not presented in *Aragona Trust* because each of three co-trustees met the 500 hour test (because they each worked "full time" for the LLC). Boy—go

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

(1) Determine the trust's distributable net income (DNI) and the items of income that comprise its DNI.

(2) Determine the items of income that comprise the trust's NII (including making subtractions as appropriate for items that are deductible in determining NII; expenses must generally be allocated between NII and non-NII items on a reasonable basis, such as proportionate to the amounts of gross income).

(3) Items of income that are deemed to be distributed under the normal DNI distributions rules (or under §642 for charitable deductions) and that also are items of NII will be deemed to be distributed NII.

(4) NII that is so determined to be distributed is taxed as NII to the recipient beneficiaries (based on their individual threshold levels).

(5) NII that is not distributed is taxed at the trust level (with its very low threshold ($12,150 in 2014, $12,300 projected in 2015)).

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

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

Dividends	$15,000
Taxable interest	$10,000
Capital gain	$ 5,000
IRA distribution	$75,000

Total	$105,000

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

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

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

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

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

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

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

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

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

> The starting point is the special rule in §662(b) for characterizing income distributed to individual beneficiaries when a charitable contribution is made from the trust. Under that rule, the charitable contribution deduction is allocated proportionately among the classes of income entering into the computation of trust income before individual distributions are characterized. Consequently, the charitable distribution is treated as paid off the top, reducing DNI and the

amount of taxable income in the various classes that individuals must report. However, in the case of individual beneficiaries to whom income is required to be distributed currently, the character of their distributions is determined by disregarding the charitable contribution deduction "to the extent that it [the deduction] exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently." Treas. Reg. §1.662(b)-2. As a result, the §642(c) deduction does not affect the DNI computation and characterization for purposes of determining the items of income distributed under a mandatory provision to an individual beneficiary.

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

Assume the same facts, except that the trust is also required to make an income distribution to B of $30,000. For purposes of determining the character of the distribution to B, DNI is $30,000. The charitable contribution deduction only reduces DNI by $20,000, the difference between the total income of the trust ($50,000) and the amount required to be distributed ($30,000). The charitable contribution is allocated proportionately to the income items ($16,000 to taxable interest and $4,000 to tax-exempt interest). B's distribution is then characterized as $24,000 of taxable interest and $6,000 of tax-exempt interest. B receives no income tax benefit as a result of the charitable distribution. In determining the amount that is included in the gross income of A, however, the entire charitable contribution can still be taken into account, with the result that for A's purposes there is no DNI and therefore no amount that A has to take into income

Comparable rules apply for determining NII in the hands of individual beneficiaries. Prop. Reg. §1.1411-3(e)(4). In the examples above, A would have no NII as a result of the trust distribution; B would have $24,000 of NII, since the tax-exempt interest portion of her distribution would constitute excluded income.

Berry, Casteel, Hall, *Charitable Planning Today,* 48TH ANN. HECKERLING INST. ON EST. PL., AT IV-A-115 (2014).

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

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

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

examples in the regulations for determining NII that is distributed, taking into consideration the deductions of expenses properly allocable to NII.)

Example. Assume the following:

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

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

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

IRA net after deduction	$10,000
Interest	$20,000
TOTAL	$30,000

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

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

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

Distributed NII: There is $16,667 of capital gain after deduction of allocable expenses, but it was not deemed distributed under the DNI rules so it is not distributed NII. There is $16,667 of interest after deduction of allocable expenses, and there is $6,667 of interest in DNI that is deemed distributed. Therefore, $6,667

of NII is distributed, leaving $26,667 of NIII after allocable expenses that is not distributed ($16,667 of capital gain and [$16,667 – 6,667, or $10,000] of interest).

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

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

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

> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary. Reg. §1.643(a)-3(b).

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

Exception (1). One possible approach is to provide in the trust agreement that capital gain is allocated to income (except for mandatory income trusts—so that the capital gains would not have to be distributed). If the distribution standard allows discretionary distributions of income or principal to all of the current beneficiaries, this would not seem to have any economic impact. The "consistently exercised" requirement does not apply under the § 1.643(a)-3(b)(1) regulation in which capital gain is allocated to income if there is no unitrust provision. Example 4 of Reg. §1.643(a)-3(e) confirms this result. The example involves a trust instrument stating that "pursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income." The example concludes that capital gains are included in DNI.

Another possibility is to give the trustee the *discretion* to allocate gains from the sale or exchange of trust assets to income. Treas. Reg. §1.643(b)-1, which was amended at the same time as §1.643(a)-3(a), provides a definition of income. It states:

> For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year *determined under the terms of the governing instrument and applicable local law*. Trust provisions that *depart fundamentally from traditional principles of income and principal will generally not be recognized*. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and *proceeds from the sale or exchange of trust assets are generally allocated to principal.* [Sentences omitted dealing with unitrusts or the power to adjust.] *In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a* ***reasonable and impartial exercise of a discretionary power granted to the fiduciary*** *by applicable local law* ***or by the governing instrument**, **if not prohibited by applicable local law**.* This section is effective for taxable years of trusts and estates ending after January 2, 2004. (Emphasis added).

This regulation recognizes gains that are allocated to income in the discretion of the trustee under the terms of the trust instrument as long as the allocations is "a reasonable and impartial exercise of a discretionary power" and is "not prohibited by applicable local law." As an example, of what might be "prohibited by applicable local law" see *Thorman v. Carr*, 408 S.W.2d 259, 261 (Tex. Civ. App.—San Antonio 1966), *aff'd per curiam,* 412 S.W.2d 45 (1967)(trustee abused discretionary allocation power in allocating entire proceeds from sale of stock to income). The Uniform Principal and Income Act states in §103 that a fiduciary

> [m]ay administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this Act.

Reg. §1.643(a)-3(a)(1) imposes a consistency requirement if a unitrust approach is used, but otherwise **there is not consistency requirement in §1.643(a)-3(a)(1) regarding allocating capital gains to income**.

Income From Flow-Through Entities. Another possible approach is to hold assets in a partnership or LLC. Under most state laws, distributions from the entity will be treated as fiduciary accounting income rather than principal unless the distribution is part of a liquidating distribution. The entity may have capital gains that will be reported out to the partners or owners; the entity may make distributions, but those distributions will be fiduciary accounting income—so the capital gains would be included in DNI. This planning is based on a special rule for capital gains from pass-through entities that is helpful in carrying out capital gains to beneficiaries. Capital gain that is distributed in

the ordinary course of partnership operations and that is allocated to the trust on the Schedule K-1 of a partnership or LLC is permitted to pass through to the beneficiaries. *Crisp v. United States,* 34 Fed. Cl. 112 (1995); *see* Carol Cantrell, *Income Tax Problems When the Estate or Trust is a Partner,* ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 1375, 1446-47 (April 2013). Furthermore, under the Uniform Principal and Income Act (UPAIA) cash distributions from an entity are generally allocated to fiduciary accounting income unless one of several exceptions applies (the primary exception being if cash is distributed in total or partial liquidation of the entity). Therefore, under UPAIA cash distributions from a flow-through entity with capital gains that are reported to the trust are treated as being allocated to income and therefore meet exception (1) so that the capital gain from the entity would be included in DNI. (If the entity distributes less than all of its taxable income, the result may not be clear as to whether the capital gain is distributed.)

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

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

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

Exception (3). Some commentators suggest that an allocation of capital gains to corpus under Reg. §1.643(a)-3(b)(3) when "utilized by the fiduciary in determining the amount that is to be distributed" does not have to be exercised consistently from year to year. The commentator acknowledges that the IRS has not provided further guidance regarding the meaning of revised subsection (b)(3), but that subsection (b)(3) "should be applicable when the fiduciary varies the amount of a principal distribution based upon the amount of the trust's or estate's capital gains for the year," and suggests, as a practical matter, that a trustee allocating capital gains to principal under subsection (b)(3) "make a record, before the distribution if possible, of the decision to do so." Frederick Sembler, *Including Capital Gains in Trust or Estate Distributions After ATRA,* TRUSTS & ESTATES 23 (March 2013). As an example, a trustee may study the trust income and income tax brackets of the trust and beneficiaries in making a decision about what distributions to make, and the trustee might specifically acknowledge that in determining the amount of distributions it has considered the trust income tax situation and the capital gains of the trust. Arguably the capital gains have been "utilized by the fiduciary in determining the amount that is distributed" thus satisfying exception (3). This rationale extends beyond the examples in the regulations for exception (3). Those examples include: (i) a trust that is directed to hold an asset for 10 years and then sell it and distribute the proceeds (Ex. 6); (ii) amounts distributed in a year the trust terminates when all income and principal is required to be distributed (Ex. 7), and (iii) a trust requiring that one-half of the principal be distributed at a particular age, at which time the trustee sells one-half the securities and distributes the proceeds (Ex. 9). However, the suggested scenario seems to meet the literal requirements stated in exception (3) because the capital gains have been "utilized by the fiduciary in determining the amount that is distributed."

Example Clause. An example clause giving the trustee discretion to utilize the flexibilities afforded by the regulation to cause capital gains to be in DNI is as follows:

> The Trustee may allocate realized short term capital gains and/or realized long term capital gains to either trust income or trust principal, and such gains shall be includable in distributable net income, (1) to the extent that such gains are allocated to income; or (2) if such gains are allocated to principal, to the extent they are distributed to the trust beneficiary, or used by the Trustee in determining the amount distributable to the trust beneficiary, or treated consistently on the trust's books, record, and tax returns as part of a distribution to the trust beneficiary. Gregory Gadarian, *Including Capital Gains in DNI,* ACTEC 2014 Fall Meeting of Fiduciary Income Tax Committee.

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

total tax savings could be 8.4%-8.8%, and the savings may be even greater if there are state income taxes.

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

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

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

o. ***The 65-Day Rule.*** Under the 65 day rule, the fiduciary may elect to treat distributions made during the first 65 days following the close of the taxable year as if they had been made on the last day of the prior year. §663(b). (For a non-leap year, this is March 6.) An estate's or trust's taxable income may not be determined by the end of the taxable year, and the 65 day rule can be helpful in planning distributions to carry out income to multiple beneficiaries, each of whom have higher thresholds, than subjecting income to taxation at the trust or estate level (with its very low $11,950 taxable income threshold in 2013, $12,150 for 2014, $12,300 projected in 2015 for the high rates and §1411 tax).

p. ***Kiddie Tax.*** Unearned income of a person subject to the Kiddie Tax (persons under age 19 and full-time students under age 24 with unearned income over $2,000 for 2013) will be taxed at the parent's tax rate. However, each child's AGI is viewed separately from the parent's AGI for purposes of testing whether the §1411 tax applies. Few persons under age 19 or full-time students under age 24 have AGI of $200,000, so they will probably not be subject to the §1411 tax. To achieve this advantage, a separate income tax return should be filed for the child rather than having the child's unearned income included in the parent's AGI on the parent's return.

q. ***Funding Pecuniary Bequests.*** If a pecuniary bequest is funded with appreciated property, the post-death appreciation will be taxed as capital gain to the estate or trust, subject to the 3.8% tax on net investment income as well as the 20% capital gains tax (assuming the estate or trust has taxable income in excess of $11,950 in 2013, $12,150 for 2014, $12,300 projected in 2015).

r. ***S Corporation Stock and Subchapter S Trusts — Grantor Trusts, QSSTs and ESBTs.*** The §1411 surtax is applied at the grantor level for grantor trusts and at the individual

beneficiary level for QSSTs. New 2013 proposed regulations take the position that if a QSST sells its S stock, the determination of whether or not there is material participation in the S corporation's business (so that the resulting gain would qualify for the non-passive trade or business income exception) is made at the trust level, and not based on the activity of the trust beneficiary (even though the trust beneficiary is generally treated as the §678 owner with respect to S corporation stock held by a QSST).

For Electing Small Business Trusts (ESBTs), the S corporation portion of the income is taxed at the trust level regardless of distributions. The §1411 regulations have very detailed rules with a detailed example for ESBTs (designed to prevent ESBTs from claiming more than one trust threshold for the S and non-S portions of the trust). Reg. §1.1411-3(c)(3). However, if the trust's interest in an S corporation constitutes an active trade or business of the trust and the trust meets the passive activity rules (*i.e.*, the trustee meets the material participation requirement), business income from the S corporation would not be net investment income subject to the 3.8% tax.

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

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

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

The IRS received many comments complaining that CRT trustees are keeping track of this information anyway and that breaking out the items of NII and non-NII in each category of income in each Tier would not be overly burdensome. The 2013 final regulations drop the "carry out NII first" approach and instead apply the Tier system to

accumulated NII of the CRT. The tax rate of items of NII within each category would be treated as being subject to an additional 3.8% tax, and the normal categorization rules would be applied (meaning that the NII income within a particular category would be deemed to be distributed first for NII surtax purposes). Form 5227 (Split-Interest Trust Information Return) has been revised to incorporate these requirements. The Instructions to Form 5227 have a detailed listing of the netting and ordering rules for classes of income within the operation of the Tier system. The 2013 proposed regulations give CRTs the choice of applying the system in the 2012 proposed regulation (which is referred as the "simplified method,") or to apply the Tier approach adopted in the 2013 final regulation. (There may be situations in which the simplified approach achieves a better tax result. For example, excess losses in a particular Tier cannot offset income in the next Tier; under the simplified method any such excess losses would enter into the calculation of the overall accumulated NII of the trust. Also, individual beneficiaries may be below the AGI threshold for paying the surtax and the simplified method may save accounting expenses. The Preamble to the 2013 proposed regulations states, however, that the IRS might discontinue use of the simplified method "if there is no significant interest" among taxpayers in using it.)

t. ***Practical Problems That Have Arisen in Reporting NII Tax.*** Practical issues have arisen as filers have prepared Forms 8960 to report the NII tax. Sometimes confusion has arisen because of positions taken by third-party software, but often is just a result of anomalies in §1411. These issues include the following, as summarized in Diana Freda, *Many Questions Remain as First Net Investment Tax Filing Season Opens*, BNA DAILY TAX REPORT, at J-1 (July 28, 2014).

- Surprises arise on Line 18b, "Deductions for distributions of net investment income and deductions under section 642(c)."
- A trust or estate might have zero taxable income but still owe NII tax, because some deductions that may reduce taxable income to zero may not be deductible for purposes of §1411 (see paragraph I above).
- A terminating trust may allocate excess deductions to beneficiaries yet still owe a NII tax (because some deductions may not be deductible for NII purposes).
- Some of such excess deductions allocated from a terminating trust to beneficiaries may be deductible by the beneficiaries for regular tax purposes but not for NII purposes.
- Expenses may generally be allocated between NII income and non-NII income in any reasonable manner, but the same allocation must generally be used for both regular tax and NII tax purposes (*i.e*, allocating the expenses differently for regular vs. NII tax purposes may not be deemed a reasonable allocation method).
- Indirect expenses may generally be allocated any way the fiduciary wants as longs as some appropriate amount is allocated to tax-exempt interest, and third-party software may generally just allocate all expenses proportionately.
- There is uncertainty regarding whether a trust or estate materially participates in a business for purposes of the non-passive business income exception, and whether

substantial authority exists to take the position that the trust materially participates.

- There is uncertainty as to whether a trustee can aggregate its activities in a business for purposes of all trusts for which it serves as trustee or whether the 500-hour (or 100-hour test, if appropriate) must be met separately for each separate trust).
- Relying on the 100-hour significant participation activity rule is risky according to David Kirk (one of the principal draftsmen of the §1411 regulations, who is now with Ernst & Young).

10. Gift Planning Issues for 2014 and Beyond

a. ***Increased Gift Exemption.*** As of January 1, 2013, the gift exemption increased to be the same as the indexed estate tax basic exclusion amount ($5.12 million in 2012, $5.25 million in 2013, and $5.34 million in 2014). Gifts in excess of the annual exclusion ($14,000 in 2013 and 2014) and in excess of the tuition and medical expense tuition exclusion effectively "use up" the lifetime gift/estate tax exclusion amount. Perhaps the most important advantage of the increased gift exemption for many individuals will be the "cushion" effect — the ability to make gifts in excess of $1 million, but considerably less than $5 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even if "aggressive" valuations are used), which may lessen the perceived necessity to use defined value clauses to avoid paying gift taxes in making transfers.

b. ***Basis Concerns***. The differential between the 40% estate tax rate and a 20% (really 23.8% including the §1411 tax on net investment income) capital gains rate makes the basis concerns significant. The advantage of making a gift is that the appreciation is not subject to estate tax; but the disadvantage is that there is no step up in basis for that asset at death. Stated differently, there may have to be a substantial amount of appreciation in order for the 40% estate tax savings on that appreciation to offset the loss of basis step up on the full value of the asset. Carlyn McCaffrey has suggested using formula clauses to address this issue. Carlyn McCaffrey, *Tax Tuning the Estate Plan by Formula*, 33 UNIV. MIAMI HECKERLING INST. ON EST. PL. ch. 4, ¶ 403.5 (1999).

   Example: A gift is made of a $1 million asset with a zero basis. If the asset does not appreciate, the family will lose the step up in basis, and at a 23.8% rate (if the family members are in the top tax bracket), this means the family will receive a net value of $762,000 from the asset (after it is sold). If the asset is not gifted, the transfer tax implications are the same but the step up in basis saves $238,000. The asset would have to appreciate to from $1,000,000 to $2,470,000 (**247%!!**) in order for the estate tax savings on the appreciation to offset the loss of basis step up (*i.e.*, $1, 469,135 post-death appreciation x 0.40 = 2, 469,135 total gain (assuming zero basis) x 0.238 [assuming the donee is in the top income tax bracket]).

   In making these calculations, consider both federal and state income and estate taxes.

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

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

Strategies are available to avoid the loss of basis step up if gifts are made to grantor trusts. The grantor can repurchase the low-basis assets before death, so that the low-basis assets would be in the gross estate at death and get a step up in basis under §1014. (This could be worthwhile even if the grantor has to borrow money to be able to repurchase the low basis assets and get cash into the grantor trust — which does not need a stepped-up basis.) In addition, some commentators maintain that a basis step up is available under §1014 at the grantor's death for all assets in a grantor trust. *E.g.*, Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death,* 97 J. TAX'N 148 (Sept. 2002). See Item 7 above for further discussion of strategies to preserve basis step up at the taxpayer's death.

c. ***Keep in Mind Downside of Depreciation***. If the gifted asset depreciates in value, the client will be worse off, from a transfer tax standpoint, than if the gift had not been made in first place.

d. ***Emphasize Strategies That Do Not Use Gift Exemption***. To the extent possible, accomplish desired lifetime transfers with strategies that minimize using the client's gift exemption (such as with GRATs or sales to grantor trusts); maximize the estate exemption remaining at death in order to retain low basis assets to receive a basis step-up at the individual's death, although there may be non-tax reasons to make gifts using gift exemptions (such as for creditor planning purposes).

e. ***Gifting Opportunities and Concerns***. General gifting opportunities and concerns in an environment of a large $5 million indexed gift exemption include the following:

- To the extent possible, accomplish desired lifetime transfers with strategies that minimize using the client's gift exemption;
- Balance the loss of a stepped-up basis for gifted assets that are no longer owned by the individual at death;
- Address the form of gifts and whether gifts should be made in trust—reasons include GST planning (if there is remaining exemption to allocate), asset protection, divorce protection, and management protection;
- Carefully consider what assets should be transferred—for valuation discounting and leverage reasons, entities will often be used; allow time between the funding of the entity and any transfers; retain sufficient assets to provide living expenses; do not transfer personal use assets to entities; follow formalities for the entity;

- Defined value formula clauses may be appropriate for gifts or sales if the transfer utilizes most of the remaining available gift exemption amount, see Item 11 below;
- Large gifts combined with sales or other leveraged transactions afford the opportunity of removing huge amounts from the transfer tax base for estate and GST purposes;
- Sales can leverage prior gift transfers to increase significantly the transfer of future appreciation; consider sales of appreciating assets to a previously funded trust in return for AFR-interest rate long term notes; the rule of thumb is that the sale amount can be 9 times the equity value of the trust from the prior gifts; allow time to pass from the date of funding the trust with gifts and subsequent sales; See Item 12 below regarding a recent IRS attack on a sale to grantor trust transaction;
- Grantor trusts can dramatically increase the amount transferred over time by permitting tax-free compounding for the trust; if a grantor is reluctant to utilize a grantor trust because of the ongoing income tax liability, consider reducing the amount being transferred to the trust but still leaving it as a grantor trust (with someone having the flexibility to cause the trust to lose its status as a grantor trust at some point in the future);
- The gift exemption amount will increase each year with indexing ($5.0M in 2011, $5.12M in 2012, $5.25M in 2013, and $5.34M in 2014) and the decision will have to be made whether and how to use the increased gift exemption amount each year; and
- Gift splitting in order to take advantage of both spouses' large gift exemption amounts is possible if the marital assets are owned predominantly by one spouse (but there are planning complexities); for a discussion of gift splitting complexities see Item 15.e of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.Bessemer.com/Advisor.
- For very large estates, consider making a large gift requiring payment of gift tax, to reduce the estate tax if the donor survives three years (after exemptions have been used, giving $100 costs $40 of gift tax but bequeathing $100 costs $66.67 of estate tax; this opportunity is more realistic now that we have "permanent" transfer tax provisions and the possibility of repeal has receded; if the client wants to give particular assets in excess of the gift exemption amount but wants to minimize gift taxes payable currently, consider using financed net gifts as explained at Handler, *Financed Net Gifts Compared to Sales to Grantor Trusts*, 44th UNIV. MIAMI INST. ON EST. PLAN. ch. 17 (2010)).

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

- Gifts to Dynasty trust to utilize $5 million GST exemption;

- If the donor is unwilling to make further gifts, the donor may be willing to make a late allocation of GST exemption to a prior trust (and if appropriate, later do a qualified severance to have fully exempt and non-exempt GST trusts);
- Forgiveness of outstanding loans to children;
- Gifts to grantor trusts, and leveraging grantor trusts with loans or sales from the grantor;
- Equalizing gifts to children or grandchildren;
- Gifts to save state estate taxes;
- GRATs (GRATs will continue to be advantageous even with the permanent $5 million indexed gift exemption);
- Life insurance transfers (including the ability to "roll out" of split dollar arrangements);
- Deemed §2519 transfers from QTIP trusts (for an outstanding detailed discussion of planning by a surviving spouse with QTIP trusts, see Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 ¶ 1202.3 (2010)); and
- QPRTs
- These specific gift strategies are discussed in more detail in Item 5.o-aa of the "2012 Heckerling Musings and Other Current Developments" found here and available at www.bessemer.com/advisor.

g. ***Gift Strategies That Provide Some Benefit to Grantor and/or Grantor's Spouse***. Planning alternatives for providing some benefit to the grantor and/or the grantor's spouse include:

- Borrowing of trust funds by grantor;
- The use of "spousal lifetime access trusts" (sometimes referred to as "SLATs"), including concerns over whether the donee-spouse can be given a testamentary limited power of appointment broad enough to appoint the assets back into a trust for the original donor-spouse if the donee predeceases, and including potential effects of creditors rights with respect to those trusts;
- "Non-reciprocal" trusts (for example, if married individuals want to include each other as potential beneficiaries of SLATs;
- Self-settled trusts established in asset protection jurisdictions;
- Sale for a note or annuity rather than making a gift of the full amount to be transferred;
- Transferring residence to trust or co-tenancies between grantor/spouse of grantor and trust;

- A donor may choose to purchase or borrow assets from grantor trusts in return for long-term notes if the donor would like to re-acquire those assets (to be able to enjoy the income produced by those assets or to be able to achieve a basis step up at the donor's subsequent death), *see generally* Clay Stevens, *The Reverse Defective Grantor Trust*, TR. & ESTS. 33 (Oct. 2012);
- Preferred partnership freeze;
- Turning off grantor trust status (to at least minimize the continuing cost to the grantor);
- Payment of management fees to the grantor;
- Inter vivos QTIPable trust; and
- Retained income gift trust.

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

11. RESURRECTION OF "DE FACTO TRUSTEE" CONCEPT—SECURITIES EXCHANGE COMMISSION V. WYLY

a. *Summary.* Long ago, the IRS has tried to make a "de facto trustee" argument, treating a settlor as holding the powers of the trustee if the settlor exercised persuasive control over the trustee. Courts (including a U.S. Supreme Court case) rejected that "de facto trustee" argument. *SEC v. Wyly* raises concerns for estate planning advisors by treating settlors as the de facto trustee of a trust (albeit in an extreme fact situation in which the trustees always followed the settlors' directions for over a decade).

SEC v. Wyly, 2014 WL 4792229 (S.D.N.Y. September 25, 2014) (Judge Scheindlin), is the determination of the "disgorgement" remedy in a securities law violation case by the billionaire Wyly brothers. The court based the amount of disgorgement largely on the amount of federal income taxes that the defendants avoided from the use of offshore trusts, after finding that the trusts were grantor trusts and that the defendants should have paid federal income taxes on all of the income from those trusts. The court determined in particular that the "independent trustee" exception in §674(c) did not apply even though the trustees were various Isle of Man professional management companies. Three close associates of the Wylys (the family attorney, the family office CFO, and the CFO of one of the Wyly entities) were trust protectors who had the power to replace the trustees. Throughout the trust administration, the Wylys expressed their requests to the trust protectors, who relayed them to the trustees, who always complied.

The SEC (not the IRS—this is not a tax case) argued that independent trustees *always* followed the wishes of the grantors regarding investment decisions (including some very questionable investments with close relatives, unsecured loans to relatives, and investments in real estate, artwork, jewelry, collectibles, furnishings used by family members). The court noted that the Tax Court had previously rejected this theory in *Estate of Goodwyn v. Commissioner*, T.C. Memo. 1976-238, which held that whether

the independent trustee exception under §674(c) applies turns on "a power reserved by instrument or contract creating an ascertainable and legally enforceable right, not merely the persuasive control which he might exercise over an independent trustee who is receptive to his wishes." (The Tax Court's rejection of the theory was grounded in the U.S. Supreme Court's decision in *U.S. v. Byrum,* an analogous determination that retained powers to cause gross estate inclusion under §2036(a)(2) must be "ascertainable and legally enforceable powers.") The court disagreed with that long-standing analysis, pointing to the substance over form doctrine, reasoning that the trustee always followed the grantors' directions, and observing that "tax law deals in economic realities, not legal abstractions."

b. *Basic Facts*. Billionaire bothers Charles Wyly and Sam Wyly transferred stock options in four publicly traded corporations to companies owned by offshore trusts (with various financial management firms from the Isle of Man as trustees) in exchange for deferred private annuities "in a tax-free kind of transaction." This raised securities law disclosure issues as to whether the Wylys had to disclose the ownership of and trading in those companies. The tax advisors advised that public SEC filings might lead the IRS to discover and investigate the tax effects of the transfers. If the Wylys controlled the stock in the offshore trusts, that could negate the desired tax-deferred nature of the transfers to the offshore trusts and result in the U.S. income taxation of those trusts. The SEC filings might be used by the IRS as evidence that the Wylys had some degree of control over the stock. As a result, the holdings and trades in the companies owned by the offshore trusts were not reported in SEC filings. Over the next ten years, the trusts and their subsidiary companies exercised the options, separately acquired options and stock in the four companies, and sold the shares, without filing any disclosures.

After a six-week trial in the spring of 2014, a "jury found that the Wylys *always* had beneficial ownership over the options, warrants, and securities held by the [offshore] trusts" and found the Wylys liable on all counts alleged by the SEC. The court in August held a one-week bench trial to determine appropriate remedies. The SEC sought disgorgement of about $620 million. The court discussed that it had very broad discretion to determine the measure of and amount of appropriate disgorgement and decided to base the disgorgement amount primarily on the amount of income taxes that the Wylys avoided improperly by the offshore trust structure. This turned on whether the trusts were grantor trusts; if so, the Wylys should have been reported the income from the trusts on their U.S. income tax returns.

There were two sets of trusts.

- One set, referred to as the "Bulldog Trusts," were created by the Wylys as settlors for the benefit of their wives and children and several charitable organizations, but no U.S. beneficiary could receive a distribution until two years after the settlor's death. Named trust protectors could add to or substitute the charitable organizations. (The delay in distributions until after the settlors' deaths was apparently in an attempt to avoid the treatment of the foreign trusts as grantor trusts under §679, which treats any foreign trust created by a U.S. person as a

grantor trust to the extent that distributions could be made to U.S. beneficiaries; the delay argument to avoid §679 was removed in a 2010 amendment to §679.)

- The other set, referred to as the "Bessie Trusts," did not have the distribution delay provision. They were nominally funded by foreign individuals; for example the foreign settlor of some of these trusts contributed $1 and a note for $24,999 but the note was immediately forgiven. If a foreign person created the trust and the Wylys merely transferred assets to the trust for full consideration, §679 would not apply.

The trustees of all of the trusts were professional management companies located in the Isle of Man. In addition, there were three trust protectors of each trust, the Wylys' family attorney, the family office CFO, and the CFO of a Wyly-related entity. The trust protectors had the power to add or substitute charitable beneficiaries of the Bulldog Trusts and had the power to remove and replace trustees of all of he trusts.

After the trusts were created, the Wylys told the trust protectors what transactions they wanted the trusts to enter, the trust protectors discussed those recommendations with the trustees, and the trustees always followed those directions. There was no evidence of a single investment that ever originated with the independent trustees or that the trustees ever rejected *any* Wyly recommendation. There were several situations in which the Wylys directed the sales of certain assets, bypassing the trustees entirely.

c. *Court Analysis*.

(1) *Substance Over Form.* The analysis as to whether the trusts were grantor trusts started with a review of the substance over form doctrine. As applied to trusts, the substance over form doctrine looks to, among other things, "whether the taxpayer's relationship to the transferred property differed materially before and after the trust's creation," and "whether the taxpayer respected restrictions imposed on the trust's operation as set forth in the trust documents or by the law of trusts." The court concluded that the substance over form doctrine applies to the grantor trust provisions:

> The substance over form doctrine is applicable to the entire body of federal tax law, including the grantor trust provisions. Thus, even with a trust is not a "sham" – that is, where it has legitimate economic substance – it may still be taxable as a grantor trust because it satisfies an exception within the grantor trust provisions only in form. [citations omitted]

(2) *Bessie Trusts Were Grantor Trusts.* The opinion is very unclear as to its reasons for finding that the Bessie Trusts were grantor trusts. The court did find that the purported foreign grantors made no gratuitous contributions to the trusts. They were merely nominal settlors. The court strongly doubted that they ever actually transferred even the very nominal $1 or $100 stated in the agreements. Therefore, the Wylys were the real settlors of the trusts. The court's entire analysis about why the Bessie Trusts were grantors is two sentences long. The second sentence states: "Because I conclude that the purported foreign grantors made no gratuitous contributions, 'the trusts at issue [are] clearly grantor trusts taxable to the domestic grantors.' [citing "Def. Resp. to U.S."—perhaps an admission by the defendants]. That would seem to result in a conclusion that

§679 applied, but the heading of the section is titled "…Taxable Under Section 674", and footnote 218 says that because the court concludes that the Bessie Trusts (and Bulldog Trusts) "were grantor trusts under Section 674, I need not reach the issue of whether they were also grantor trusts under Section 679."

(3) *Bulldog Trusts Were Grantor Trusts; §674 Analysis*.

Section 674 Statutory Provisions. The general rule is that a trust is a grantor trust if the beneficial enjoyment is subject to a power of disposition exercisable by the grantor or a nonadverse party, without the approval of any adverse party. Therefore, the general rule is that most trusts are grantor trusts. There are various exceptions under §674(b)-(d).

Section 674(c) is the independent trustee exception. A trust is not a grantor trust if the power of disposition over the trust is "solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor."

The court reasons that the only open question regarding the application of the independent trustee exception under §674(c) is whether the independent trustees were able to exercise their powers "solely" or "without the approval or consent of any other person."

Rejection of De Facto Trustee Argument and Estate of Goodwyn v. Commissioner. The court acknowledged the 1976 case that rejected the IRS's "de facto trustee" argument—that the grantor in effect was the trustee in light of the actual operation of the trust. The court acknowledged the holding in Estate of *Goodwyn v. Commissioner* (T.C. Memo. 1976-238) that §674(c) refers to "an ascertainable and legally enforceable right, not merely the persuasive control which [the grantor] may exercise over an independent trustee who is receptive to his wishes." To this 38-year old doctrine, which planners have assumed to be well established, the court responds "I disagree."

Economic Realities Control. The court reasons that the economic realities are that the Isle of Man trustees were acting at the direction of the Wylys, so the independent trustee exception of §674(c) did not apply. The court reached this conclusion with strong language that conceivably could be extended broadly to other contexts:

> I disagree. "Such a rigid construction is unwarranted. It cannot be squared with the black-letter principle that 'tax law deals in economic realities, not legal abstractions.'" [citing *PPL Corp. v. C.I.R.*, 133 S.Ct. 1897, 1905 (2013) (quoting *CIR v. Southwest Exploration Co.*, 350 U.S. 308, 315 (1956))] As Professor Danforth, the defendants' own expert, writes in his treatise, "[i]t would certainly violate the purpose of the independent trustee rule to require an independent trustee to act with the consent of the grantor or a related or subordinate person." The Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. The Wylys expected that the trustees would execute their every order, and that is exactly what the trustees did.

> The evidence amply shows that the IOM trustees followed every Wyly recommendation, whether it pertained to transactions in the Issuer securities; making unsecured loans to Wyly enterprises, or purchases of real estate, artwork, collectibles, and other personal items for the Wylys and their children. The trustees made no meaningful decisions about the trust income or corpus other than at the behest of the Wylys. On certain occasions, such as the establishment of the Bessie Trusts [with their nominal foreign grantors], the IOM trustees actively participated in fraudulent activity along with the Wylys. The Wylys freely directed the distribution of trust assets for personal purchases and personal use. Because the Wylys and their family members were beneficiaries, the IOM trustees were thus "distributing" income *for* a beneficiary at the direction of the grantors—the Wylys.

d. *Planning Observations*.

(1) *Significant Even Though Not a Tax Case*. This is not a tax case, so why should we be concerned about this case, even if the judge did seem to upset what planners had thought was established principles? This was a decision by the federal district court (and by a very respected federal district court judge); this judge would have reached the same conclusion if this had been a tax refund case arising from claims by the IRS rather than a case arising from SEC allegations. The IRS has not raised the "de facto trustee" argument (particularly in the context of §674(c)) for decades. In light of this federal district court opinion, however, the IRS may be more inclined to raise this argument in the future—and beyond just the §674(c) grantor trust context. Perhaps, though, this is just a "terrible facts make bad law" case that will not give rise to a growing use of future similar attacks by the IRS in tax cases.

(2) *Rejection of De Facto Trustee Argument in Estate of Goodwyn.* In *Estate of Goodwyn v. Commissioner*, T.C. Memo. 1976-238, two attorneys served as the trustees of a trust, but at all times, with the acquiescence of the trustees, the grantor "made all decisions with respect to the purchase and sale of trust assets and the investment of any proceeds and determined the amounts, if any, to be distributed to the respective beneficiaries." The IRS argued in that case that based on the grantor's relationship to the trust management and administration, "he should be deemed to be a trustee, in fact, during his life." The Tax Court rejected that approach, noting that the U.S. Supreme Court (as well as a prior *Goodwyn* case) have held that an analogous provision in §2036(a)(2), requiring estate inclusion in a decedent's gross estate if the decedent retained the "right" to designate who shall possess or enjoy property transferred by the decedent, applies only if the decedent held "an ascertainable and legally enforceable power" reserved in the trust instrument or by some other means (citing *United States v. Byrum*, 408 U.S. 125, 136037 (1972)). Based on that analysis, despite the terrible facts suggesting that the grantor in fact made all trust decisions, the Tax Court in *Goodwyn* concluded that the "power" of disposition for independent trustees in §674(c) refers to

> a power reserved by instrument or contract creating an ascertainable and legally enforceable right, not merely the persuasive control which he might exercise over an independent trustee

> who is receptive to his wishes. Such interpretation is also, we believe, indicated by the holding [in] the Byrum case.
>
> In this case, the trustees in question accepted the rights, duties and obligations granted them in the trust instruments. Regardless of the fact they had entrusted to the decedent the complete management and control of these trusts, this informal delegation did not discharge them from the legal responsibility they had as the trustees. As a matter of law, the trustees were liable and answerable for the decedent's acts on their behalf. See 2 Scott, Trusts 1388, 1391 (3rd ed., 1967); 3 Scott, Trusts 1794 (3rd ed., 1967).
>
> There is nothing in the record to show that the trustees could not have undertaken exclusive control of the trust res if they had elected to do so. Whatever power Goodwyn exercised over the trust assets, administration or distribution, he did so [in] the trustee's behalf and not in his own right.

T.C. Memo. 1976-238.

(3) *Goodwyn and Byrum Broadly Relied on By Planners.* Planners for years have been comfortable naming close relatives of grantors or beneficiaries as trustees without fear that a court would later determine that the grantor or beneficiary should be treated as holding the powers of the trustee because of the close relationship, even if the grantor or beneficiary had a significant amount of persuasive influence with the trustee. This reliance has been grounded, in substantial part, on cases like *Goodwyn*¸ as well as the *Byrum* Supreme Court case—cases that have looked to who held the "ascertainable and legally enforceable power."

The U.S. Supreme Court made this position clear in *United States v. Byrum* with strong language that planners have relied on:

> In our view, and for the purposes of this case, O'Malley [United States v. O'Malley, 383 U.S. 627 (1966)] adds nothing to the statute itself. The facts in that case were clearly within the ambit of what is not §2036(a)(2). That section requires that the settlor must have "retained for his live … the *right* … to designate the persons who shall possess or enjoy the property or the income therefrom." O'Malley was covered precisely by the statute for two reasons: (1) there the settlor had reserved a legal right, set forth in the trust instrument; and (2) this right expressly authorized the settlor, "in conjunction" with others, to accumulate income and thereby "to designate" the persons to enjoy it.
>
> It must be conceded that Byrum reserved no such "right" in the trust instrument or otherwise. The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power, such as that involved in O'Malley. Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.

United States v. Byrum, 408 U.S. 125 (1972).

The Tax Court relied on *Byrum* to reach the conclusion in a prior *Goodwyn* case that the settlor's actual administration of the trust, despite the fact that he was not the trustee, did not result in the settlor being treated as holding the powers of

the trustee to cause the trust assets to be included in the settlor's gross estate under §2036(a)(2):

> In the course of the trial of this case, and in his briefs, respondent made no secret of the fact that support for respondent's position was to come from the decision of the U.S. Supreme Court in the case of United States v. Byrum then pending on writ of certiorari from the U.S. Circuit Court of Appeals for the Sixth Circuit. The Supreme Court has since rendered its decision in that case. By that decision, the Supreme Court has rejected the position of the respondent in the instant case that the de facto exercise of control over the management and investment of the trust res is within the ambit of section 2036.
>
> … [Quotations from *Byrum* case omitted]
>
> The right or power upon which the tax is predicated must thus be a legal right reserved in the trust instrument, or at least by some form of agreement between the trustees and the settlor. Admittedly, such a right did not exist in the case of the … Trusts. To hold otherwise would not only be contrary to the reasoning of the Supreme Court in the Byrum case but would present the insuperable problem of determining to what degree compliance on the part of unrelated trustees with the wishes of the grantor would be sufficient to constitute requisite control over the trust res within the meaning of section 2036.
>
> It would indeed be an unusual situation for a grantor to appoint trustees, whether corporate or otherwise, in the expectation that such trustees would, where given a choice, act contrary to the wishes and intent of the grantor. Notwithstanding that [the third party trustees] permitted the decedent full discretion in the management of these trusts, as a matter of law the trustees were responsible and answerable for the decedent's acts on their behalf. See 2 Scott, Trusts 1388 (3d ed., 1967); 3 Scott, Trusts 1794 (3d ed. 1967). Had they so elected, [the third party trustees] could have taken control of the trust res at any time.

Estate of Goodwyn v. Commissioner, T.C. Memo. 1973-153.

(4) *Possible Extension of Wyly Analysis to Other Contexts.* The analysis in *Wyly* could be extended beyond just the independent exception to the grantor trust rules in §674(c). The same reasoning might be used to treat as grantor as being deemed to hold the powers of the trustee to make distributions beyond a "determinable external standard" that might cause inclusion of trust assets in the grantor's gross estate under §§2036(a)(2) or 2038. That precise argument was rejected by the Supreme Court in *Byrum* and by the Tax Court in the earlier *Goodwyn* case (involving the same estate) as well as other cases. It might also conceivably be extended to a §2041 analysis. If a son is named as trustee of the credit shelter trust with his mother as a discretionary beneficiary, and if the mother is an "overbearing mama" who calls all the shots in the family, might the IRS argue that the mother is treated as holding the powers of the trustee to trigger §2041? Planners have not worried about those concerns in the past in selecting trustees.

While the specific facts of *Wyly* involved settlors acting through trust protectors, the fact that trust protectors were involved is not central to the court's decision. The court's arguments would be just as strong, and even stronger, if there had

been no trust protectors and the settlors had exerted their "persuasive" influence directly on the trustees.

The IRS has on rare occasion made the de facto trustee argument, especially in offshore trust cases. *E.g., Weigl v. Commissioner,* 84 T.C. 1192 (1985) (treating offshore trustee as a mere nominal trustee); Pvt. Ltr. Rul. 9043074. Perhaps this case simply highlights that if grantors egregiously control every trust decision and are allowed to act for the trust with the trustee's consent, the IRS will treat the grantors as trustees.

(5) *IRS Has Restricted Its Argument that the Persuasive Control of Being Able to Remove and Replace Trustees Causes the Person Holding the Removal Power to Hold the Trustee Powers.* The IRS kept losing its argument that trustee removal powers should cause trustee powers to be attributed to the grantor or beneficiary who held the removal power. *Estate of Vak v. Commissioner*, 973 F.2d 1409 (8th Cir. 1992); *Estate of Wall v. Commissioner*, 101 T.C. 300 (1993). The IRS eventually in Revenue Ruling 95-58, 1995-2 C.B. 1, conceded that trustee removal powers would not cause the remover to be treated as holding the trustee powers as long as the remover had to appoint a successor who was not a related or subordinate party. (Various private letter rulings have extended the logic of Rev. Rul. 95-58 to concluded that removal powers by beneficiaries will not trigger estate inclusion in the beneficiary's estate under §2041 if the removed trustee must be replaced with an independent trustee. *E.g.,* Ltr. Rul. 201432005.)

This history regarding removal powers and the ultimate concession by the IRS in Rev. Rul. 95-58 is a further indication of the extent to which the courts and even the IRS stipulate that legally enforceable powers control, not the power to persuade (or brow beat) a trustee with the constant threat of removal hanging over the trustee's head. In *Wyly*, the settlors exercised their power by asking the trust protectors to relay their wishes the trustee, who knew that the trust protectors held the removal powers over the trustees. If the settlors had instead held the removal powers directly rather than through trust protectors, Rev. Rul. 95-58 assures that this persuasive/brow beating influence could not have resulted in the settlors being treated as if the held the trustee's powers under §2036(a)(2) as long as they had to replace the trustee with another independent trustee.

(6) *Planning—Pay Attention to Actual Administration of Trusts*. Trustees should have a process for making investment and distribution decisions, and should *document* their reasons for decisions that they make. Seeking the input of the settlors or beneficiaries of a trust is not a problem (and indeed is often encouraged). The *Wyly* opinion noted the testimony of one of the defendants' attorneys that the trustees followed the settlors' recommendations "when it came to the four securities that were in companies that the Wylys were more familiar with than anyone in the world." (Footnote 73). Even so, trustees should document their reasons for decisions on behalf of the trust—particularly distribution decisions. (Indeed, an occasional "no" to requests by the settlor or a beneficiary may help evidence the trustee's independence.) The *Wyly* court emphasized that the trustees *never* said no, but *always* followed the Wylys' directions.

(7) *Trust Protectors With Broad Grantor-Like Powers.* There is a growing trend toward naming trust protectors with very broad powers, including the broad ability to amend trusts, change beneficial interests, veto or direct distributions, modify powers of appointment, change trustees, or terminate the trust—all in the name of providing flexibility to address changing circumstances, particularly for long-term trusts. The *Wyly* case points out how that could backfire if a pattern of "string-pulling" by the settlors occurs in practice with respect to the exercise of those incredibly broad powers. Planners will not stop using trust protectors in the future in light of *Wyly* but should be aware of potential tax risks that can arise if the broad trust protector powers are abused by overbearing settlors.

12. Defined Value Clause Updates

a. ***General Description.*** In making transfers of hard-to-value assets, clients are concerned that gift taxes may result if the assumed value at the time of the transfer ends up being lower than the value that is finally determined for gift tax purposes. Two types of clauses have emerged to define what is transferred by formula in order to avoid (or diminish) the gift tax risk—(1) formula allocation clauses and (2) formula transfer clauses.

b. ***Formula Allocation Clauses.*** A "formula allocation clause" allocates the amount transferred among transferees (*i.e.*, transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees include charities, spouses, QTIP trusts, "incomplete gift trusts" (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and "zeroed-out" GRATs. With this type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values.

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

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

As to the public policy issue, the court quoted the Supreme Court's conclusion that public policy exceptions to the Code should be recognized only for "severe and immediate" frustrations, and analyzed why the three public policy issues raised in the *Procter* case do not apply. First, the opinion responds to the concern that the clause would discourage the efforts to collect taxes by reasoning that the IRS's role is to enforce the tax laws, not just to maximize revenues, and that other enforcement mechanisms exist to ensure accurate valuation reporting. As to the second and third policy concerns raised by *Procter*, the court responded that the case is not "passing judgment on a moot case or issuing merely a declaratory judgment," because the effect of the case causes a reallocation of units between the donors and the donees. The court noted in particular that prior cases addressing the public policy issue have involved situations in which charities were involved in the transfers, but concluded that the lack of a charitable component in these transfers does not result in a "severe and immediate" public policy concern.

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

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

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

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

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

Similarly, a sale could be structured with the assignment being of that number of shares equal to the specified purchase price. Recently filed companion cases concern an IRS attack on a sale to grantor trust transaction, in which the sale agreement included a *Wandry*-type provision describing the amount of units being sold in terms of the finally determined value that is equal to the specified purchase price. *Estate of Donald Woelbing v. Commissioner*, Docket No. 30261-13; *Estate of Marion Woelbing v. Commissioner*, Docket No. 30260-13 (discussed in Item 12 below).

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

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

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

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

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

A practical impact of the *Wandry* case is that before that case, agents would just give a very simple short one sentence response to formula clauses: "We don't' respect formulas." That is no longer the case.

There were likely a number of *Wandry* transfers made in late 2012. Gift tax returns for many of them were likely filed in the late summer/early fall of 2013, and gift tax audits will begin emerging regarding those transfers later this year. (Bruce Stone reports that a number of estate and gift tax agents are being detailed to go to Cincinnati to go through the flood of gift tax returns that were filed for 2012.)

Some commentators suggest that the issue more important than whether the *Wandry* clause is respected to determine the *amount* that is transferred, is whether the gift tax audit/case causes a final determination of the *extent* of property transferred. They suggest that there is a risk that years after the gift tax audit, the IRS might contend that the gift tax audit/case merely determines a gift tax deficiency and does not preclude the IRS from later claiming that the donor/seller continued to be the owner of a larger fraction of the property. *See* Austin Bramwell & Brad Dillon, *Not Another* Wandry *Article: Real Issue With* Wandry *Formulas*, 41 EST. PLANNING (May 2014).

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

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

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

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

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

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

Agents on occasion have questioned whether sales for notes bearing interest at only the meager AFR should be recognized. (There are some indications that the *Karmazin* case [discussed below], which received a great deal of attention in 2003, initially

arose because of the agent's concern over use of the AFR as the interest rate on an intra-family sale transaction.)

The IRS is attacking some huge SCIN transactions in *Estate of Davidson*. The frontal assault on "standard" sale to grantor trust transactions comes to the forefront in two companion cases recently filed in the Tax Court.

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

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

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

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

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

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

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

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

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

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

c. ***Using AFR as Interest Rate for Notes in Intra-Family Sale Transactions***. As a practical matter, many intra-family sale transactions use notes having an interest rate equal to

the AFR rather than the higher §7520 rate. Sections 1274 and 7872 were enacted soon after the *Dickman* case and address valuing gifts from below market loans. Those sections (which constitute the basis for the AFR) seem to contemplate cash loans, but there is authority that AFRs under §7872 can also be used for sale transactions. *See Frazee v. Commissioner*, 98 T.C. 554, 588 (1992)("Nowhere does the text of section 7872 specify that section 7872 is limited to loans of money. If it was implicit that it was so limited, it would be unnecessary to specify that section 7872 does not apply to any loan to which sections 483 or 1274 apply. The presence of section 7872(f)(8) signaled Congress' belief that section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of section 7872, but rather, to apply the provision as drafted."); *True v. Commissioner*, T.C. Memo. 2001-167 ("We concluded in Frazee v. Commissioner, supra at 588-589, that section 7872 does not apply solely to loans of money; it also applies to seller-provided financing for the sale of property. In our view, the fact that the deferred payment arrangement in the case at hand was contained in the buy-sell agreements, rather than in a separate note as in Frazee, does not require a different result."), *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004).

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

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

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

d. ***Planning Implications.***

Careful Planning Required. The *Woelbing* cases are a reminder that sale to grantor trust transactions require careful planning (and there was detailed planning in the sale transaction involved in that case). Planners should be aware (and advise clients) that the IRS is alleging in some cases that the note has a zero value and that the seller

makes a gift of the entire value that is transferred. Whether the IRS will prevail is another question altogether, but sales transactions with grantor trusts are clearly sophisticated transactions requiring careful detailed planning considerations.

The planner should pay particular consideration to taking steps to cause the transaction to be treated as a "bona fide transaction" so that the note will be respected as debt rather than being treated as a retained equity interest in the trust. (If the note is treated as an equity interest in the assets that are transferred, the IRS argues that §2702 applies for gift tax purposes and that §§2036 and 2038 apply for estate tax purposes because those Code sections all involve interests retained in the transferred property itself.) Cases have listed a variety of factors that are considered by courts in determining whether intra-family loan or notes transactions are respected. *E.g.*, *Miller v. Commissioner*, T.C. Memo. 1996-3. (As an analogy, there are debt/equity principles that are applied under §385 in the context of shareholder loans.) There are no "safe harbor" regulations for intra-family sale transactions like we have for GRATs.

Defined Value Feature. The defined value feature of the sales agreement may become more common, especially following the *Wandry* case (T.C. Memo. 2012-88). Two prior cases (*Petter* and *Hendrix*) have recognized sale transactions with a defined value element in which "excess value" over a stipulated amount passed to charity. The clause in *Woelbing* does not involve an excess amount passing to charity but, like the gift transaction in *Wandry* (though the 2006 transaction happened long before the *Wandry* case was decided in 2012), merely defines the amount transferred in terms of a specified value amount. *Woelbing* could be the first Tax Court case addressing the validity of a "*Wandry*-type" clause in sales transactions. See Item 11 above regarding defined value clauses generally and Item 11.d regarding the use of defined value clauses in sales transactions and a summary of prior cases (*King*, *McLendon*, and *Harwood*) that have addressed the validity of "price adjustment" clauses.

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

14. Same-Sex Marriage Issues

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

a. ***Windsor***. In 1993, Edie Windsor and Thea Spyer registered as domestic partners under New York law. They were married in Canada in 2007 and New York deemed their marriage to be valid. Thea died in 2009, naming Edie as her executor and leaving her

estate to Edie. Edie filed the estate tax return for Thea's estate and claimed the marital deduction. The IRS denied the deduction on the basis of Section 3 of DOMA. Edie paid the estate tax and sued for a refund in New York federal court.

The federal district court found in Edie's favor and held that Section 3 of DOMA was unconstitutional, and ordered a refund of $363,000 in federal estate taxes plus interest. On appeal, a divided Second Circuit also held that Section 3 of DOMA was unconstitutional.

The Supreme Court, in a 5-member majority opinion written by Justice Kennedy, ruled that Section 3 of DOMA (which defines marriage as the legal union of one man and one woman for purposes of federal laws and regulations) is unconstitutional. The majority opinion was rather murky on the precise constitutional reasoning, but determined that Section 3 of DOMA violates basic due process and equal protection principles under the Fifth Amendment. The court also points to the Fourteenth Amendment (but without any analysis how the Fourteenth Amendment specifically applies and whether a "strict scrutiny," "intermediate scrutiny," or "rational basis" analysis under the Fourteenth Amendment applies in this context), by observing that the equal protection of the Fourteenth Amendment makes the Fifth Amendment right "all the more specific and all the better understood and preserved." The court's reasoning that Section 3 is unconstitutional results in a conclusion that it was always unconstitutional and the Court's holding is applied retroactively.

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

c. ***Revenue Ruling 2013-17***. The day after *Windsor* was decided, the Internal Revenue Service announced that it is working with the Department of Treasury and Department of Justice and "will move swiftly to provide revised guidance in the near future" regarding how federal tax laws will be applied in light of the *Windsor* case. That guidance was published on August 29, 2013 in Rev. Rul. 2013-17.

Rev. Rul. 2013-17 has three holdings and a clarification regarding its prospective application.

(1) *Terms Relating to Marriage Include Same-Sex Couples.* "For Federal tax purposes, the terms 'spouse,' 'husband and wife,' 'husband,' and 'wife' include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term "marriage" includes such a marriage between individuals of the same sex." There is nothing surprising about this holding, and it was fully expected following the *Windsor* decision.

(2) *Place of Celebration Standard*. "For Federal tax purposes, the Service adopts a general rule recognizing a marriage of same-sex individuals that was validly entered into in a jurisdiction (whether a state, district, territory or foreign country) whose laws authorize the marriage of two individuals of the same sex even if the married couple is domiciled in a place that does not recognize the validity of same-sex marriages." This holding, adopting a "place of celebration" test rather than a "place of domicile" test, was anticipated but by no means certain. For further discussion of the place of celebration issue, see paragraph d below.

(3) *Domestic Partnerships and Civil Unions Not Included*. For federal tax purposes, the interpretation of terms to include same-sex couples does "not include individuals (whether of the opposite sex or the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state…" This holding is the most administratively feasible approach. Prior IRS private rulings have afforded favorable tax treatment to Illinois civil union partners and to California registered domestic partners. *E.g.,* PLR 201021048 (each California domestic partner reports half of community property income). A practical difficulty is that some states that recognize domestic partnerships or civil unions provide that the couple has all of the rights and privileges afforded married couples but some states do not. Drawing a distinction based on the degree to which state laws afford such relationships the benefits of marriage would have been cumbersome at best.

(4) *Prospective Application*. The holdings are applied prospectively as of September 16, 2013 (the date that the Ruling will be published in 2013-38 I.R.B. 201). Affected taxpayers may rely on the ruling "for the purpose of filing original returns, amended returns, adjusted returns, or claims for credit or refund for any overpayment of tax..., provided the applicable limitations period for filing such claim under section 6511 has not expired." All items on such return or claim that are affected by the marital status must be reported consistently. Similarly, taxpayers may rely retroactively on the ruling with respect to overpayment of employment tax and income tax with respect to tax-exempt employer-provided health coverage benefits or fringe benefits that are based on an individual's marital status.

Notice IR-2013-72 expands on the discussion of the prospective application, and makes crystal clear that same-sex married couples must file 2013 federal income tax using either "married filing jointly" or "married filing separately" filing status. For prior tax years, however, the taxpayer can choose whichever is the better result regarding the individual's marital status:

> Individuals who were in same-sex marriages may, but are not required to, file original or amended returns choosing to be treated as married for federal tax purposes for one or more prior tax years still open under the statute of limitations.

The Notice points out that refund claims can still be filed for tax years 2010, 2011, and 2012. The Notice does not point out that refunds also can be filed for 2009 income tax returns until October 15, 2013 if the due date for filing the return was extended to October 15, 2010.

If an amended return is filed, the couple will be treated as married for all purposes on that "return or claim"; for example, the attribution rules under §267 might apply. There is no indication that the couple must be treated as married for all federal tax purposes during that prior year; for example, a couple may be able to file a claim for refund of gift taxes for a prior year to claim the marital deduction without having to treat the couple as being married for income tax purposes during that same year.

One commentator has observed that the IRS may at some point wish it had not been so explicit in stating that there would be no assessment for underpayment in prior years (for example, if filing jointly would have produced a higher income tax due to the "marriage penalty"), because this position may be precedent for a similar non-assessment if some future statute that protected an abusive transaction is later determined to be unconstitutional. Karibjanian, *George Karibjanian on Revenue Ruling 2013-17 and IR-2013-72: The Service Responds to Windsor,* LEIMBERG ESTATE PLANNING NEWSLETTER #2137 (September 3, 2013).

That same commentator points out that some taxpayer will likely challenge the inability to obtain a refund for closed tax years based on the theory that the finding that DOMA was unconstitutional means that it was *void ab initio*. However, the Mr. Karibjanian believes that the Service would likely win that argument because the ability to file a protective claim for refund provided an adequate remedy, but that the remoteness of a statute's unconstitutionality should be considered as a factor to reopen the statute of limitations. *Id.* The Supreme Court in *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco, Dept. of Business* (1990), addressed the constitutionality of not allowing refunds for prior payments of a state tax that was held to be unconstitutional under the Commerce Clause. That case suggests that refunds will not have to be given for closed years. There may be relatively few "closed year" issues that will arise because Massachusetts was the only state that recognized same-sex marriages until 2008.

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

Rev. Rul. 2013-17 states that the IRS will give further guidance in the future regarding the retroactive application of *Windsor* to employee benefits and employee benefit plans and arrangements. (For example, what if the surviving party of a same-sex marriage did not previously receive the benefits of a spouse rollover or other benefits available to spouses under the minimum distribution rules?)

The retroactivity impact of the *Windsor* decision arises in various contexts. While the reasoning in *Windsor* that Section 3 is unconstitutional results in a conclusion that it was always unconstitutional, issues will arise in allowing retroactive administrative relief. For example, the Pentagon's decision to make the full spousal benefits available to same-sex married couples allows benefit payments retroactive only to June 26, 2013, the date of the *Windsor* decision. The Office of Personnel Management has announced that for federal employees, benefits will be available for same-sex spouses regardless of their state of residency, but puts a limit on the retroactive effect of the availability of benefits:

> Because existing same-sex marriages were not recognized by the Federal government before this Supreme Court decision, all legal same-sex marriages that predate the decision are being treated as new marriages; enrollees will have 60 days from June 26, 2013 (i.e., until August 26, 2013) for enrollment actions.

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

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

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

heirs; heightened consideration concerning burial instructions for departed spouse; and eliminating adverse tax consequences for the transfer of property pursuant to a marriage settlement agreement. (Availability of some federal benefits will depend on whether the same-sex couple lives in a recognition state or non-recognition state.)

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

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

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

> revisit estate planning documents for marital deduction planning and gifting strategies;
>
> review beneficiary designation forms, retirement plans and employer provided benefits; review grantor trust status of trusts; revisit income tax issues; review and update marital agreements if necessary and possible; rethink drafting issues concerning conflict of law issues and definition of spouse for purposes of the testator/testatrix and grantor—but also for class gifts, fiduciary appointments, and permissible appointees under power of appointments for documents created by strangers to the same-sex marriage; update healthcare proxies, living wills, and durable power of appointments (and advise clients to take such instruments with them when they travel); make sure both same-sex spouses adopt children regardless of the marital presumption of any particular state; filing claims for refunds for any taxes paid that would not have been owed if the *Windsor* decision had been in effect at the time (or requesting relief under Sections 301.9100-1 through 301.9100-3 depending on the particular circumstances); and advising fiduciaries to file claims for refunds, even if applicable period as run, or be exposed to potential liability by beneficiaries for breach of trust.

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

h. ***Impact on State Law Issues***. In *Hollingsworth, et al. v. Perry et al.*, 133 S. Ct. 2652 (2013), the Supreme Court let stand lower court decisions holding that California's Proposition 8 (which said that only a marriage between a man and a woman would be valid in California) was unconstitutional. (The Supreme Court did not reach the merits of the constitutional issue but held that the individual citizens who brought the case did not have standing to pursue the case.) In *Windsor*, the Supreme Court did not address Section 2 of DOMA, which allows states to refuse to recognize same-sex marriages performed under the laws of other states.

This issue will be addressed by future courts. (Ultimately, it is likely that the Supreme Court will address the constitutionality issue.) The outcome will impact a number of

important estate planning issues for same-sex couples, including elective share rights, homestead rights, allowances for spouses, and community property rights.

The first post-*Windsor* case to address the issue is *Obergefell v. Kasich,* Case No. 1:13-cv-501 (S.D. Ohio Western Div., July 22, 2013). The federal district court awarded a temporary restraining order compelling the state registrar of death certificates to later record the deceased person in a same-sex marriage as "married," notwithstanding state law prohibiting the recognition of same-sex marriages from other states. The federal court held that the state law would likely not survive constitutional muster. The basic facts are that James and John are Ohio residents and had been in a committed relationship for 20 years. During the course of John's hospice treatment, the couple flew to Maryland in a special medically equipped jet, were married on the tarmac in Maryland, and then flew home that same day. John has ALS and is certain to die soon. The couple sued for an order declaring as unconstitutional an Ohio law forbidding recognition of legal same-sex marriages from other states, and moved for a preliminary injunction ordering the state registrar of death certificates, upon John's later death, to record his status as "married" with James as his spouse. The Ohio federal court granted the preliminary injunction to the couple on the grounds that: (1) they are legally married in Maryland; (2) following the U.S. Supreme Court decision in *Windsor*, they have a substantial likelihood of prevailing at trial and success on the merits because the Ohio law violates the U.S. Constitution; (3) without a temporary restraining order, the last official record of John's life will be incorrect, will fail to recognize his spouse, will hinder his burial with his spouse at a family plot that is limited to family and spouses (or his burial will be delayed or exhumation will be required, and there will be irreparable emotional hardship during his end of life period; (4) there is no harm to the state or its citizens from granting the order; and (5) the public interest is promoted by the robust enforcement of constitutional rights.

A somewhat similar state law case is *O'Connor v. Tobits*, No. 2:1-cv-00045 (Dist. Ct. E. Pa, July 29, 2013). The surviving spouse of a same-sex couple who married in Canada and resided in Illinois (which recognized the validity of the marriage) did not sign a waiver of the right to receive survivor benefits of a qualified profit sharing plan. The decedent's parents were named as the beneficiary. The Retirement Equity Act of 1984 requires automatic survivor benefits that can be waived only with the proper consent of the participant and spouse. The court determined that the survivor is the "surviving spouse" under the *Windsor* case and ruled that the surviving spouse is entitled to the benefits rather than the parents because she did not consent to a waiver of the survivor benefits.

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

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

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

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

j. ***Retirement Plan Issues.*** Notice 2014-19, 2014-17 I.R.B. 979, provides guidelines regarding same-sex issues for qualified retirement plans. The Notice clarifies that plans need only reflect the *Windsor* decision (and recognize same-sex marriages) as of June 26, 2012 (the date of the decision). Section 401(a) contains various requirements that qualified plans must satisfy in term of providing rights and benefits for spouses of married participants; those are the rights that the plan must recognize as of June 26, 2012. A plan will not be treated as failing to meet the §401(a) requirement, however, merely because the plan, prior to September 16, 2013 (the date of Rev. Rul. 2013-17) recognized a same-sex spouse only if the participant was domiciled in a state that recognized same-sex marriages. (Stated differently, the plan must apply a "state of celebration" standard as of Sept. 16, 2013.) A plan may be amended to recognize same-sex marriages before June 26, 2013, but the IRS cautions that may trigger requirements that are difficult to implement retroactively. If the plan terms are not consistent with recognizing same-sex marriages, the plan must be amended by the later of (i) the deadline under Rev. Proc. 2007-44, or (ii) December 31, 2014.

k. ***Conclusion and Caution***. It is clear that the *Windsor* decision will provide numerous planning opportunities and benefits to same-sex spouses that were not previously available. There will, however, also be costs, the uncertainty of major unresolved constitutional questions, and complications arising from state legislative reactions to *Windsor* and the seemingly inevitable future litigation. Differences between federal and state law in this respect may add some complexity to planning, but the federal benefits are almost certain to justify dealing with that complexity.

15. Charitable Planning Reminders, Strategies and Creative Ideas

a. ***Charitable Intent Needed.*** Do not get the "tax cart before the horse." A client must have charitable intent for any of these alternative strategies to make sense. Turney Berry advises: "If you are dealing with someone who does not want to give something to charity, I have a tip for you—don't talk to them about charitable gifts."

b. ***Deduction for Contributions to Private Foundations Limited to Basis.*** A frequent malpractice scenario is when planners fail to advise clients that the charitable

deduction is limited to the donor's cost basis for contributions of appreciated property to a private foundation unless the contribution is of cash or marketable securities.

c. ***Substantiation Requirements***. In *Durden v. Commissioner*, T.C. Memo. 2012-140, an income tax charitable deduction was denied for the taxpayers' $25,171 of contributions to their church. They received a receipt from the church and had cancelled checks, but the letter did not have the required sentence that the taxpayer did not receive any goods or services. The receipt of a letter from the church after the taxpayers received the notice of deficiency was not sufficient. The court agreed that it was a terrible result, but said that it was bound by the statute. Similarly, a deduction was denied in *Mohamed v. Commissioner*, T.C. Memo. 2012-152 in which the court said "[w]e recognize that this result is harsh – a complete denial of charitable deductions to a couple that did not overvalue, and may well have *undervalued*, their contributions – all reported on forms that even to the Court's eyes seemed likely to mislead someone who didn't read the instructions. But … Congress was quite specific … and we cannot in a single sympathetic case undermine those rules."

d. ***Contribution of Assets With Potential Liability Concerns Can be Made to Single Member LLC.*** Notice 2012-52 provides that for purposes of §170(b) (*i.e.*, for income tax purposes) a gift to a single member LLC owned by the charity is treated as a contribution to the charity. To avoid confusion, the IRS encourages the charity to disclose in its acknowledgement of the contribution that the LLC is wholly owned by the charity and is treated by the charity as a disregarded entity. This can be very helpful, for example, if someone is contributing real estate (with inherent liability for accidents occurring on the property or with a potential environment liability). The charity could form a single member LLC to hold the property to segregate any liability associated with the property from the charity's assets. Presumably, the IRS will apply the same rule for purposes of the gift and estate tax charitable deduction.

e. ***Private Foundations Substitutes: Donor Advised Funds and Supporting Organizations.***

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

Supporting Organizations. Additional limitations were also imposed in 2006 on what types of organizations can qualify as supporting organizations (SOs), and some planners may think that supporting organizations are no longer workable alternatives. That is not the case. The "garden variety-easy kind" of SO still makes sense. H and W want to support three public charities. They create an SO with H, W, and a representative from each of the three charities on the board, so that the charities control the SO's board. That clearly qualifies as a "Type I" qualified SO. For any particular decision, H and W just need to get one of the three charitable representatives to go along with them. The clients may feel comfortable with this arrangement. There is a practical limit on how many charities could be added to the board for this purpose. A board of 14 family members and 15 charitable members would not qualify, because there are too many charity representatives for any one of them to feel any real supervision responsibility. The dividing line is not objective, but

the key to getting any charitable organization application through the IRS is to "be vanilla." An application with any complications will take 2-3 years to get approved. The group that approves exempt organization application requests is just now reviewing applications filed in May 2012 that have any complexity to them. (The IRS Service Center in Cincinnati that reviews these applications receives 5,000 applications per month.)

f. ***Defined Value "Formula Allocation" Clauses With Excess Value Passing to Charity.*** Four cases have approved transactions with formula clauses that allocate to charity transferred property in excess of a stated dollar value. Those types of defined value clauses are viewed as more reliable than "*Wandry*-type" clauses. See Item 11.b above.

g. ***IRA Charitable Rollover.*** The ability of a taxpayer over age 70½ to make a distribution directly from his or her IRA to a charity of up to $100,000 was extended only through 2013. However, it has a good chance of being extended again (although perhaps not until late in 2014, or perhaps even in early 2015 retroactive back to January 1, 2014). If a client is going to make a large charitable contribution in any event, the client may want to go ahead and have the IRA make the distribution to charity (perhaps only up to the amount of the required minimum distribution that has to be made during the year). The worst that happens if the provision is not extended is the taxpayer is treated as having made a taxable withdrawal of an amount from the IRA he was going to withdraw anyway and made a charitable gift he was going to make anyway. If the IRA charitable rollover is extended, advantages of making the contribution from the IRA are that the percentage limitations on charitable deductions and the phase out of itemized deductions do not apply; furthermore the taxable income that is avoided is removed from the taxpayer's adjusted gross income, which may result in the taxpayer being below the $200,000/$250,000 AGI threshold for the 3.8% tax on net investment income.

h. ***Charitable Remainder Trusts for IRAs.*** Charitable remainder trusts (CRTs) may be an attractive vehicle to receive IRAs. Examples of possible uses are listed.

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

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

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

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

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

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

j. ***Advantage of Charitable Contributions By Trusts for NII Purposes.*** Trust distributions to charity qualify for a deduction for purposes of the 3.8% tax on net investment income, whereas charitable deductions by individuals do not impact the amount of NII tax. See Item 9.j above.

k. ***Additional Advantage for Giving Appreciated Assets—To Avoid NII Tax.*** The traditional advantages of giving appreciated assets to charity (rather than selling the assets and making a charitable contribution of the sale proceeds) include that the donor gets a charitable deduction for the full value of the assets without having to recognize any of the gain. Another advantage of avoiding the capital gain income from the sale is that the capital gain would have increased the donor's AGI (perhaps putting the donor over the NII tax threshold), and even if the donor is over the NII tax threshold, the donor will have avoided receiving that capital gain income (now subject to the additional 3.8% tax on net investment income).

l. ***Non-Grantor CLATs.*** CLATs structured as non-grantor trusts receive no upfront income tax deduction, but the trust income is not taxable to the grantor over the term of the

trust. The trust can make the annual contributions to charity that the donor would otherwise have made. Assets in the trust that the donor would otherwise have owned can produce income that is not owned by the grantor; this achieves a better result than if the donor had received the income and made the charitable contribution because there are no percentage limitations on charitable deductions for trusts, the phase-out of itemized deductions does not apply to trusts, and the trust investment income may be offset by the charitable deduction for purposes of the 3.8% tax on net investment income. For a discussion of planning considerations with charitable lead trusts, see Item 57 of the ACETC 2013 Summer Meeting Musings found here and available at www.Bessemer.com/Advisor.

m. ***Shark Fin CLATs.*** "Shark Fin CLATs" are charitable lead trusts that have a very low charitable payment for most years, with dramatically increasing payments at the end of the CLT term. There is no guidance from the IRS as to whether they are acceptable. PLR 201216045 approved a charitable lead trust with an annuity that increased by 20% each year. The regulations and revenue procedures provide that CLATs may permit annuity increases, but they do not specify an acceptable amount of the increases. The GRAT regulations limit increases to 20% a year, but the GRAT regulations do not apply to CLATs. The basic advantage of Shark Fin CLATs is that the (hopefully) appreciating-high performing assets in the CLAT can remain in the CLAT longer, thus increasing the amount of assets remaining to pass the family members following the end of the CLAT term. A concern structuring the CLAT with extremely low payments for many years is that the trust income may exceed the charitable distributions, thus leaving the trust with substantial taxable income subject to annual income taxation at the trust level.

   Another alternative is that the charity may decide to sell its "lead" interest to the family (and in particular to the remainder beneficiaries of the CLAT). Under the current interest rate environment, the charity's lead interest is valued assuming that it will have a yield of about 2% per year, *i.e.*, the annuity stream of payment is discounted at only 2% to arrive at the present value of the annuity stream, which produces a high present value of the income stream. The charity might run calculations assuming that it would be able to earn about 5% on the sale proceeds over the term of the CLAT, and it might be willing to sell the annuity stream using a discount rate of 5% (which would produce a significantly lower number than the value of the annuity stream produced by the Treasury tables, but may be a much more realistic estimate of the actual value of the annuity stream to the charity over the long term of the CLAT). The charity would believe that it will have more overall receipts from the sale proceeds and growth and earnings on the sale proceeds than if it merely receives the annuity payments each year. In such a case, the charity "might be hard-pressed to refuse to sell the annuity stream." The family may be happy to pay for the charity's interest if it thinks the trust growth and income on the trust assets can exceed 5% per year. None of the panelists addressing CLATs have structured CLATs to last in excess of 40 years.

n. ***Charitable Gifts by Partnerships Flow-Through to Trust-Partners.*** Rev. Rul. 2004-5 provides that a trust that is a partner is entitled to a charitable deduction for the trust's distributive share of the charitable gift from the partnership's gross income—

even if the trust has no charitable beneficiaries. The deduction is not disallowed under §642(c) "merely because the trust's governing instrument does not authorize the trustees to make charitable contributions." The key to receive a charitable deduction for a trust under §642(c) is that the contribution must be from income. Similarly, the contribution from the partnership must be from partnership income in order for the trust to use the charitable deduction.

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

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

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

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

What if the children own the 1% voting stock and the client gives its 99% non-voting interest to charity, appraised with a 30% discount. If the company buys the charity's stock at a 30% discount, the entire $3 million discount amount increases the children's wealth. (Still, the client must have charitable intent for that to make sense.)

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

if, for example, the client wants to satisfy a big charitable pledge a transaction like this could accomplish the charitable gift goal and also accomplish a wealth shift to a trust for the client's children at the same time.

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

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

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

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

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

16. RESIDENCE AND DOMICILE ISSUES—STATE INCOME TAX ISSUES

a. ***State Income Taxes—Generally***. Forty-four states have a state income tax. The top rates range from 3.07% (Pennsylvania) to 13.3% (California). State income taxes are quite significant for planning since they are paid every year—not just at death.

b. ***Residence***. State income tax is generally based on residence (rather than domicile). Residents are generally taxable on all income, whereas nonresidents are only taxable on income attributable to real property, tangible personal property, and business activity within the state (typically referred to as "source income"). Residence is based on bodily presence. The states vary, but the typical test is to treat an individual as a

resident if the individual is physically present in the state for more than 183 days during the year. (Presence anytime during a day counts, unless the presence is merely traveling through the state.) Some states (example, Delaware) also require a place of abode in the state to be a resident. Some states apply their income tax if the individual is either domiciled or a resident of the state,

c. ***Domicile***. A person's domicile is a place where the person has been physically present and *intends* to remain permanently, and the permanent home to which the person intends to return if the person leaves. State death taxes are typically based on the decedent's domicile.

d. ***Double Taxation Risk.*** Two or more states may claim that an individual is a resident or domiciled in the state, which can result in double taxation. States often provide no credit for taxes paid to another state. Commuters who live in one state and work in another state must be very careful about this. For example, an individual who lives in Pennsylvania but works in Delaware would want to be careful not to purchase a "place of abode" (even a vacation home) in Delaware; otherwise the individual may be taxed both in Delaware and Pennsylvania.

e. ***Changing Domicile.*** Domicile is like super glue—it is easy to get on but really hard to get off. To change domicile, the taxpayer must abandon the old domicile, establish a new domicile, and establish the intent to remain at the new domicile indefinitely. That must normally be proven by clear and convincing evidence.

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

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

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

   See Item 20.d of the 2012 Heckerling Musings found here and available at www.Bessemer.com/Advisor for a summary of the court cases that have addressed the

constitutionality of state tax systems that tax trusts based on the testator of a testamentary trust or settlor of an inter vivos trust residing in the state. Based on those cases, most commentators believe that taxing a nonresident trust solely because the testator or settlor was a resident is probably unconstitutional. However, if that state's court system is utilized, for example, because of a probate proceeding in that state, chances are better that the state does have the authority to tax the trust.

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

Practice Pointer: If a state taxes a trust based solely on the resident status of the settlor when the trust was crested, the tax is likely unconstitutional. The planner must decide between filing returns each year and taking the position on the returns that the trust is not a resident in order to cause a statute of limitations to run (which puts the state taxing authority on notice to audit the return), or not filing with the risk that the state years later could seek taxes, penalties and interest.

17. Inherited IRAs Not Protected in Bankruptcy, *Clark v. Rameker*

The U.S. Supreme Court, in a unanimous decision, held that assets in an IRA inherited by a non-spouse beneficiary after the death of the IRA owner are not "retirement funds" and are not protected under in bankruptcy under §522(b)(3)(C). *Clark v. Rameker,* 573 U.S. __ , 134 S. Ct. 2242 (2014). The case resolved a split among circuit courts.

Several states have exemptions for inherited IRAs under state law (including Alaska, Arizona, Florida, and Texas). This case does not impact (i) creditor's claims in non-bankruptcy matters or (ii) claims in bankruptcy matters for debtors who live in states with state law exemptions for inherited IRAs who elect to apply the state law exemptions rather than federal bankruptcy exemptions.

The case directly involves an IRA that was inherited by a daughter, not the surviving spouse. The opinion suggests that spousal rollover IRAs would be protected, but the opinion was not explicit in discussing how spousal rollover IRAs will be treated. A possible result is that an

IRA inherited directly by a spouse will not be entitled to the federal bankruptcy exemption, but after the spouse elects to treat the IRA as her own or rolls the IRA into a rollover IRA, it would thereafter be recognized as "retirement funds" qualifying for the federal bankruptcy exemption. If that is the result, an open question is whether either of those actions by the surviving spouse will be treated as a fraudulent transfer if a claim is outstanding at the time of such action.

The opinion may result in more retirement fund owners planning to leave plan assets for beneficiaries in "accumulation trusts" rather than leaving the accounts directly to the beneficiary. Trusts with spendthrift provisions can be protected from the beneficiary's creditors. A problem with planning to rely merely on the state law exemptions, for accounts living in states with state law exemptions, is that the creditor exemption status is based on where the beneficiary resides, and that may change prior to the account owner's death.

Accumulation trusts can receive retirement account funds as beneficiary and must receive distributions from the retirement account (at which time the distributions are recognized as taxable income) over the life expectancy of the oldest possible beneficiary of the trust. A problem with leaving a retirement account or IRA payable to an accumulation trust for a surviving spouse, instead of making it payable to the spouse directly, is that the spouse would not be able to roll over the account into his or her own retirement account or IRA, and distributions could not be delayed as long as if the funds were in a rollover account.

A possible planning strategy may be to name the surviving spouse directly as the initial beneficiary, name an accumulation trust for the spouse's benefit as the secondary beneficiary, and name an accumulation trust for descendants as the tertiary beneficiary. This gives the spouse the flexibility to rollover the assets into a spousal rollover account, disclaim the direct bequest so that the account passes to an accumulation trust, or have the assets pass to an accumulation trust for descendants (if there is no surviving spouse or if the spouse disclaims the first two beneficiary designations). *See* Ed Morrow, *Clark v. Rameker: Supreme Court Holds that Inherited IRAs Are Not Protected in Bankruptcy. Are Spousal Inherited IRAs and Even Rollover IRAs Threatened As Well?,* LISI ASSET PROTECTION PLANNING NEWSLETTER #248 (June 16, 2014); Denicolo, Gassman & Ketron, *Clark v. Rameker: Supreme Court Rules that Inherited IRAs Are Not Creditor-Exempt in Bankruptcy,* LISI ASSET PROTECTION PLANNING NEWSLETTER #251 (June 26, 2014). For an excellent discussion of structuring issues for accumulation trusts vs. conduit trusts in light of the *Clark* case, see Mary Vandenack, *Reconsidering the Design of Trusts Used as IRA and Qualified Account Beneficiaries Post-Clark*, LISI ASSET PROTECTION PLANNING NEWSLETTER #252 (July 7, 2014).

APPENDIX A

Formula General Power of Appointment With Tiered Formula Based on

Individual Assets Carrying Highest Tax Burden

Provided by Richard Franklin (Washington D.C.)

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

1. General Power of Appointment Over Asset #1 of the Appreciated Assets. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #1. The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate, will not result in or increase the federal estate tax payable by reason of my spouse's death. The denominator of the fraction shall be the value of Asset #1 as of my spouse's death. Asset #1 shall mean that asset from among the Appreciated Assets (as defined hereinbelow), if any, that if sold by the By-Pass Trust immediately prior to my spouse's death would generate the greatest aggregate amount of federal and state income tax.

2. General Power of Appointment Over Asset #2 of the Appreciated Assets. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #2. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate, will not result in or increase the federal estate tax payable by reason of my spouse's death over (b) the denominator of the fraction in Paragraph 1 above. The denominator of the fraction shall be the value of Asset #2 as of my spouse's death. Asset #2 shall mean that asset from among the Appreciated Assets, if any, that if sold by the By-Pass Trust immediately prior to my spouse's death would generate the second greatest aggregate amount of federal and state income tax.

3. General Power of Appointment Over Asset #3 of the Appreciated Assets. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #3. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate, will not result in or increase the federal estate tax payable by reason of my spouse's death over (b) the sum of the denominators of the fractions in Paragraphs 1 and 2 above. The denominator of the fraction shall be the value of Asset #3 as of my spouse's death. The Asset #3 shall mean that asset from among the Appreciated Assets, if any, that if sold by the By-Pass third greatest aggregate amount of federal and state income tax.

4. Additional General Powers of Appointment Over Additional Assets of the Appreciated Assets. I give to my spouse additional testamentary general powers of appointment following the pattern of Paragraphs 1 – 3 over additional assets of the Appreciated Assets, with each successive asset of the Appreciated Assets being that asset of the By-Pass Trust subject to the next highest aggregate amount of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse's death. The numerator of the fraction of each successive power of appointment shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate, will not result in or increase the federal estate tax

payable by reason of my spouse's death over (b) the sum of the denominators of the fractions used in the prior powers of appointment.

5. Last General Power of Appointment. Notwithstanding the above, the last general power of appointment granted by this Section shall be the power whose fraction has a numerator less than its denominator.

6. Appreciated Assets of the By-Pass Trust. For purposes of this Section, the term "Appreciated Assets" shall mean those assets owned by the By-Pass Trust upon my spouse's death the income tax basis of which may increase (and not decrease) pursuant to Section 1014(a) of the Code if such assets passed from my spouse within the meaning Section 1014(b) of the Code [OPTIONAL PROVISION: ,provided, however, that any Family Assets shall be considered last (and then classed based on greatest aggregate amount of federal and state income tax in a similar manner as provided above) For purposes of this Section the term "Family Assets" means ______ (*e.g.*, the family farm or private family company, which is unlikely to be sold in the near future, etc.)]. For this purpose, blocks of shares of the same stock in the same company and having the same basis shall be consider as a block as one asset.

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

THIS SAMPLE FORM IS A DRAFT FOR CONSIDERATION BY PLANNERS. THERE IS NO WARRANTY FOR ITS USE FOR ANY PURPOSE. IT IS INTENDED ONLY TO PROVIDE GUIDANCE TO A PRACTITIONER IN DRAFTING AND SHOULD NOT BE RELIED UPON FOR ANY OTHER PURPOSE.

APPENDIX B

Sample Form of Contingent General Power of Appointment

Provided by:

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Section X. Contingent Powers of Appointment. Notwithstanding any provision herein to the contrary except the provisions of Section 3 of PART IV and in addition to any other power of appointment granted hereunder, each beneficiary of any trust hereunder (an "Applicable Trust") who is a member of the most senior generation of the beneficiaries of such trust (an "Applicable Beneficiary") shall have the following powers:

Contingent General Power of Appointment to Reduce Death Taxes. Each Applicable Beneficiary shall have the power to appoint the smallest fractional share of an Applicable Trust, if any, that would reduce to the minimum the aggregate federal and applicable state estate tax and generation-skipping transfer taxes ("Death Taxes") payable upon the Applicable Beneficiary's death. If the Applicable Beneficiary has a power of appointment equivalent to the power under this paragraph (a) with respect to other trusts, the Applicable Beneficiary's power under this paragraph (a) shall apply to the Applicable Trust in the proportion that the value of the Applicable Trust bears to the value of all such trusts to which the Applicable Beneficiary has such a power of appointment. If any trust property is included in the estate of an Applicable Beneficiary for purposes of any Death Taxes as a result of this power of appointment, the Trustee shall pay over to the Applicable Beneficiary's estate, or pay directly, from such property, an amount equal to that increment of such tax liability attributable to the inclusion of such property in the Applicable Beneficiary's estate.

Contingent General Power of Appointment to Reduce Capital Gains Taxes. Each Applicable Beneficiary shall have the power to appoint those Appreciated Assets of an Applicable Trust that (i) are not subject to a power of appointment under paragraph (a) preceding; (ii) have in the aggregate a value less than or equal to the largest amount that would not cause an increase in the Death Taxes payable upon the Applicable Beneficiary's death; and (iii) have in the aggregate the greatest Appreciation. If the foregoing power may apply to some but not all assets with the same Appreciation as a percentage of basis, it shall apply to all those assets in the proportion that the value of each such asset bears to the total value of all such assets. The following rules and definitions shall apply to this paragraph:

If the Applicable Beneficiary is the beneficiary of more than one trust that includes the power provided in this paragraph (b) or an equivalent power, the following provisions shall apply:

Trusts with the Same Remainder Beneficiaries shall be aggregated and treated as a single trust for purposes of applying the power in this paragraph (b).

With respect to all other trusts, the power under this paragraph (b) shall apply in the proportion that the value of the Appreciated Assets in each such trust bears to the value of the Appreciated Assets in all such trusts.

"Trusts with the Same Remainder Beneficiaries" shall mean trusts for which, after taking into account any exercise by the Applicable Beneficiary of a power of appointment over such trust other than a power granted under this paragraph (b), the identity and type of interests of the vested and contingent remainder beneficiaries are identical; provided, however, that differences in the timing of the distribution of property, differences in whether distribution is outright or in trust, and differences in powers of appointment held by beneficiaries following the Applicable Beneficiary's death shall not be considered.

"Appreciated Assets" shall mean property that, if included in the Applicable Beneficiary's estate for purposes of Chapter 11 of the Code, would have its basis determined pursuant to Section 1014(a)(1), 1014(a)(2) or 1014(a)(3) of the Code immediately after the Applicable Beneficiary's death, subject to the limitations of subparagraph (4) following.

With respect to an Applicable Trust that (i) has an inclusion ratio of zero, as defined in Section 2642(a) of the Code, and (ii) does not pass on the Applicable Beneficiary's death, in default of the exercise of the power of appointment, solely to non-skip persons, as defined in Section 2613 of the Code, assets of such Trust shall not be Appreciated Assets to the extent that the value of such assets exceeds the Applicable Beneficiary's exemption from generation-skipping transfer tax pursuant to Section 2631 of the Code available at the time of the Applicable Beneficiary's death, reduced by the value of any transfers occurring at the Applicable Beneficiary's death, other than pursuant to this paragraph (b) or an equivalent provision, to which an effective allocation of the Applicable Beneficiary's exemption from generation-skipping transfer tax could be made.

"Appreciation" shall mean the amount by which the value of property exceeds its income tax basis immediately prior to the Applicable Beneficiary's death.

General Provisions Applicable to this Section. For purposes of determining the property, or fraction thereof, subject to a power of appointment provided under this Section: Taxes shall be computed assuming that the power is not exercised.

Property shall be valued in accordance with Chapter 11 of the Code applied as if such property were included in the Applicable Beneficiary's estate.

The Trustee may rely on information provided by the legal representative of an Applicable Beneficiary's estate in determining the trust property subject to the power of appointment.

A power of appointment under this Section may be exercised by an Applicable Beneficiary by will duly admitted to probate upon any terms and conditions, including further trusts, to or for the benefit of the creditors of the Applicable Beneficiary's estate. No exercise of this power of appointment shall be effective unless it shall make specific reference to this provision. Any portion of such property which such Applicable Beneficiary shall not have effectively appointed shall be distributed as otherwise provided in this Trust Agreement.

THIS SAMPLE FORM IS A DRAFT FOR CONSIDERATION BY PLANNERS. THERE IS NO WARRANTY FOR ITS USE FOR ANY PURPOSE. IT IS INTENDED ONLY TO PROVIDE GUIDANCE TO A PRACTITIONER IN DRAFTING AND SHOULD NOT BE RELIED UPON FOR ANY OTHER PURPOSE.