Issue 36 – January, 2021

NAEPC Journal of Estate & Tax Planning

New! Download the **entire issue as one PDF file** for offline reading.

Features

How COVID-19 and Interest Rates Affect Life Insurance (PDF)
An industry expert discussess two major developments in 2020 that you should be aware of now.
Reproduced courtesy of **Trusts and Estates**
Author: Richard L. Harris, CLU®, AEP®

Thirty-two Core Beliefs (PDF)
Holistic ways for practitioners to achieve a good estate-planning result.
Author: L. Paul Hood, Jr., JD, LL.M. (taxation), CFRE, FCEP

The Human Side of Estate Planning: Part 1 (PDF)
The first installment of an important three-part series. The second and third installments will appear in our next issue.
Author: L. Paul Hood, Jr., JD, LL.M. (taxation), CFRE, FCEP

Spirit of Holiday Giving Can Infuse Your Estate Plan (PDF)
Marty gives an important reminder that estate planning is not just about transmitting wealth but also transmitting values.
Initially published in Forbes.com
Author: Martin Shenkman, CPA/PFS, MBA, JD, AEP® (Distinguished)

Understanding Grantor Trusts (PDF)
An in-depth history and review of grantor trust rules, history, and tips on identifying a grantor trust.
Author: Steven Siegel, JD, LL.M. (taxation)

Planning for the Personal Injury Attorney's Client (PDF)
Considerations when planning for a client's settlement and how to protect any benefits being received.
Author: Karen Dunivan Konvicka, JD

4 Reasons Why Right Now Is The Best Time To Gift A Closely Held Business (PDF)
Author: Audra M. Moncur, CPA/ABV

News Nook: A Compendium of Current Affairs

The Improved Power to Plan: NY Amends Its Power of Attorney Forms and Laws (PDF)
An overview of planning considerations under new law in 2021 in New York.
Authors: Brian M. Balduzzi, Esq., LL.M. (taxation), MBA, CFP® and Alan D. Kroll, Esq.

Key Business Valuations Addressed by Tax Court (PDF)
Summary of a recent key valuation case that validates a valuator's

approach and method of valuation.
Reproduced courtesy of Leimberg Information Services, Inc. (LISI)
Authors: Evan Levine, ChFC® and Nainesh Shah, CFA

New Actuarial Tables are Coming (PDF)
Commentary regarding pending release of new actuarial tables by the IRS.
Reproduced courtesy of Leimberg Information Services, Inc. (LISI)
Author: Lawrence P. Katzenstein, JD, AEP® (Distinguished)

Steve Oshins Releases 9th Annual Dynasty Trust State Rankings Chart (PDF)
An easy-to-use summary of leading Dynasty Trust states, along with expert commentary on additional benefits identified in the chart.
Reproduced courtesy of Leimberg Information Services, Inc. (LISI)
Author: Steven J. Oshins, JD, AEP® (Distinguished)

Notes from the NYU Advanced Trusts and Estates Conference (PDF)
Reproduced courtesy of Leimberg Information Services, Inc. (LISI)
Author: Mary E. Vandenack, JD, CAP®

NAEPC Monthly Technical Newsletter
Reproduced courtesy of Leimberg Information Services, Inc. (LISI)

William D. Kirchick, Esq., AEP®
Nutter McClennen & Fish LLP
Boston, Massachusetts

Happy New Year!

Welcome to another issue of the *NAEPC Journal of Estate & Tax Planning*!

NAEPC is pleased to provide its designees, certificants, affiliated local estate planning councils, and their members with this forum, a centralized and convenient location for best-in-class thought leadership for the estate planning professional. The scholarly articles within allow a professional to stay current on planning ideas and to strengthen his/her awareness of continually changing planning opportunities, while enhancing communication and cultivating a common language between all of the disciplines within the membership.

As the nation's premier, multi-disciplinary estate planning organization, NAEPC is committed to providing members and friends with timely, pertinent education materials and I believe the *NAEPC Journal of Estate & Tax Planning* truly supports that pledge. I trust you will find it a compelling read and hope that you will find it useful in gaining knowledge about the latest ideas in sophisticated estate planning techniques to enable you to provide the highest quality of service available to your clients – excellence in estate planning.

Being in the midst of a pandemic, NAEPC has endeavored to provide practitioners with advice on how to engage in practice management remotely. Therefore, you will find a wealth of information and articles in our **COVID-19 Resource Library**. We hope to display timely articles on the topic in the Journal, as well.

If you have missed any of the past issues, you can find them archived right here on the Journal's website. If you are not receiving notice of new issues directly, please be sure to **subscribe**. While you are with us, please take a moment to take a look at information n about upcoming educational **conferences** and **webinars**, the **Accredited Estate Planner**® (AEP®) designation, and **Estate Planning Law Specialist** certification.

Best wishes for a happy and prosperous new year.

Editor's column:

Early last March, our family cancelled a weekend getaway at the very last moment – the car was already packed, and the kids were in their seats. Our plans suddenly changed due to some worrisome news spreading across the country – something called COVID-19. Later that same day, our Governor issued a stay-at-home order. Little did we know that life would never be the same. The virus was clearly not the only historical or memorable event in 2020, a year that no one will ever forget. Change came fast and furious, whether you were prepared or not.

As estate planners, we face constant change and uncertainty. For example, what will the Democrats do in Washington? Will the tax laws change now, next year, after the next election or via legislative "sunset" in 2026? How will government stimulus and relief packages impact our clients' families, businesses, communities, and non-profits? What will our own industries and organizations look like in the future as a result of all the change? If I listed all the uncertainties, this column would never end!

Fortunately, our profession is no stranger to change. For example, many of us have actually witnessed and can explain a "sunset" to our clients who think it's new or not real. Although specific estate planning tools and strategies change each year, many core values and principles of estate planning do not. The content in this issue of the NAEPC Journal of Estate and Tax Planning shows that while some things always change and require adaptation, some never do and require adherence. The material includes timely and hard-hitting content about current topics and possible changes ahead. The material also includes timeless reminders that our client's goals and objectives always come first, regardless of their net worth or tax picture.

I wish to close by expressing my sincere thanks and gratitude to Susan P. Rounds, JD, CPA, LL.M. (taxation), AEP®, TEP for her significant contributions to this publication as Editor and Chair of the Publications committee; and for her service to NAEPC as a member of the Board of Directors. In March 2016, Susan authored a column that referenced the "*Masters Among Us.*" The *Masters* she referred to included NAEPC Hall of Fame members, our wonderful AEPs, and the industry members that contribute to this Journal. Many of these individuals still contribute to the Journal, including this issue. Susan truly elevated the practice of estate planning through her career and tenure with NAEPC. She must be considered a *Master* herself. On behalf of NAEPC and its leadership, we wish Susan the best in her future endeavors and thank her again for her tireless leadership over the years.

Happy Reading!

Ryan P. Laughlin, CPA, MST, JD, AEP®

Editor - NAEPC Publications Committee

Estate Planning for the 99 Percent: With No Estate Tax, Consider Income Tax, Financial and Personal Objectives

Prepared by: Steven Siegel, JD, LLM (Taxation) © 2020

I. Overview

The estate planner has new challenges—the majority of our clients' estates will not be subject to the federal estate tax when death occurs. How are we to plan for them—and indeed, convince them that planning is still important and necessary? This outline discusses the new reality in financial and estate planning.

2020 is a special year. As the result of the Covid-19 virus, our lives and our clients' lives have been uprooted like never before. Focus for many has turned to earning income, paying bills and employees, and of course, protecting our families and ourselves. Income tax filings and payments are delayed, required minimum distributions from retirement plans are suspended for 2020, penalties for early withdrawals from retirement plans are excused, and allowable loans from 401k plans are increased. The government is trying to keep employees and employers afloat with a wide range of relief provisions.

With the virus and the new law provisions confronting us daily, we may lose sight of the need for other planning considerations. That would be a mistake. The combination of the available generous transfer tax exclusions, the decline of the stock market, the low market interest rates and the concern about political risk with the coming 2020 election presents a "perfect storm" of planning opportunity. As difficult as it may seem, we need to look beyond the terrible virus story and consider planning opportunities for our clients and ourselves.

As of 2020, as the result of the 2017 Tax Cuts and Jobs Act, the applicable exclusion from the federal gift and estate tax is $11,580,000. This number is indexed annually for inflation. The 2020 exclusion from the generation-skipping transfer tax (GST) is $11,580,000, also indexed for inflation.

These increased exclusion amounts sunset after 2025 and revert to the 2017 exclusion amounts ($5,490,000) as further indexed for inflation. Code Section 2010 (c)(5).

Clients whose estates fall under these thresholds will be referred to as persons of "moderate wealth" for purposes of this discussion.

The American Tax Relief Act of 2012 (ATRA) also made permanent the concept of portability, which allows the surviving spouse to use the unused federal estate tax exclusion of a deceased spouse (called the "DSUE") who died after 2010. Depending on the estate plan of the first deceased spouse and the year of death, portability can give the surviving spouse an available applicable exclusion for lifetime gifting and use at death of $23,160,000 in 2020. The GST exclusion is not portable.

In 2001, 120,000 federal estate tax returns were filed, of which 60,000 were for taxable estates. In 2010, 15,000 returns were filed. In 2012, less than 4,000 taxable estate tax returns were filed. Estimates are that less than 0.1 percent of Americans—fewer than 2 out of every 1,000 people who die—will be subject to the federal estate tax with the current exclusion structure in place. The Tax Policy Center suggests that only 1,800 estates in the United States (1 in every 1,400 people who die) will pay any estate tax in 2020.

II. The New Normal in Estate Planning—Simplicity and Client Resistance?

If clients no longer fear the imposition of costly transfer taxes and the complex planning needed to avoid such taxes, will clients be willing to embrace complex planning and the professional fees often associated with such complexity?

The client may want to opt for the most simple (and least expensive) of plans, which may make complete sense when viewed solely as a current tax planning decision, but which may be a serious mistake when other planning considerations are raised. The challenge for the planner will be to convince the client that "simple" from the tax standpoint does not always translate to simple or even correct from a wide range of other perspectives.

It is certainly likely that many persons will take a "do it yourself" approach to planning. Will, trust, and many other document forms are readily available on the internet and in book stores. Moreover, many people are aware of the changes in the law and the absence of federal tax liability. Many will therefore decide to save the cost of professional planning fees, believing that there are no penalties for failure since no tax will be owed, regardless of what they sign or do. Such a decision can be a huge mistake for some families.

III. A New Emphasis in Planning

A. Refocused Planning

The major focus for estate planning for married couples having assets under $22.36 million will turn to core dispositive planning, income tax planning (such as achieving basis step-up at death), and the preservation and management of assets.

B. Core Dispositive Planning

Planning should begin with a review of the clients' current personal and financial situation and an examination of the current estate plan and all associated documents. The planning should consist of several considerations, including (*a)* the desired beneficiaries to whom assets should be given or bequeathed; (*b)* coordination of beneficiary designations, which is still required to achieve the desired result, and (*c*) a review of the client's existing estate planning documents from a new perspective.

As you review the client's existing documents, do formula clauses that made sense in a different tax environment still work? Take great care if the client's documents still include formulas referring to the "maximum amount that can pass without tax consequences" being left to children and the balance of the transferred property to the spouse. Will there be any balance? Be careful of formulas leaving the surviving spouse only enough assets to reduce the federal estate tax to zero. The applicable exclusion may get to zero long before a marital gift is needed. Are the formulas still needed if the client lives in a *decoupled state* (a state that still has an independent death tax with exclusions well below the federal level of tax exclusions)? Is there still a need for a credit shelter trust that no longer may be needed to generate federal estate tax savings?

What gifts has the client made? If they were made to trusts, how are the trusts structured and how are they operating? Are the trustees currently in place and are those persons or institutions named as likely successors the right choices? If there has been a pattern of gifting to family members that was motivated by transfer tax concerns that no longer apply, what are the expectations of those family members? A discussion may be needed.

Look at beneficiary designations of items that pass outside of a will (life insurance policies, retirement plans, jointly held property). If trusts designed to achieve transfer tax savings are designated beneficiaries, perhaps they are no longer desired or necessary.

A real concern for the planner in this situation is the motivation of the client. In the pre-ATRA and pre-2017 TCJA worlds, taxes were a primary motivating factor. "I will plan your estate and save you taxes" was an acceptable way to overcome the client's reluctance to address planning. Now, estate tax savings has been largely or completely removed from that picture. The challenge for the planner is to get the client to focus on the non-estate tax aspects of planning which remain of primary importance.

C. Areas Where Estate Planning Is Still Required

1. Planning for the disposition of the client's assets at his or her death
2. Asset protection planning (protection from creditors and predators)
3. Planning for disability and incompetency
4. Business succession planning – pay attention to the baby boomer generation of business owners approaching retirement age (with or without concerns that the estate tax will force a succession plan to be implemented)
5. Planning for possible divorce and other family relationship dissolutions
6. Charitable giving (for its own sake, not for death tax savings, and because income tax considerations will still be relevant; techniques such as lifetime charitable remainder trusts or gifts to donor advised funds are worthwhile to consider as a way to "bunch" the charitable deduction to allow an advantage for itemizing deductions)

Planning Suggestion: Gifts to charity made at death in an estate that will not be subject to the federal estate tax gains no tax benefit for the decedent's estate or the decedent's heirs. Consider instead leaving property to children and have them promise to make the desired gifts to the decedent's favorite charities. The children can gain a valuable income tax deduction for doing so. Code Section 170. Alternatively, if the children are not "trusted" to make the desired gifts to charity, have the client instead create and fund a trust directed to make mandatory distributions of the trust income to charity over a number of years. Properly drafted, with the charitable direction in the governing instrument, the Code Section 642(c) charitable deduction will offset the trust income and satisfy the charitable intent of the creator of the trust.

7. Life insurance planning (other than to provide funds to pay death taxes)

8. Fiduciary litigation (may become a greater problem because there is more to fight over as an inheritance with taxes out of the picture)

9. Retirement planning. The SECURE Act of 2019 has created new challenges in its limitation of the opportunity to stretch out payments for the lifetimes of many beneficiaries

10. Planning to pay state death taxes (in those states that have decoupled from the federal system and have their own death tax)

11. Planning to avoid or minimize gift taxes (if the client desires to give away more than the indexed applicable exclusion amount for gift tax purposes – or if the client is concerned about the sunset provision or an earlier reduction in the exclusion amount resulting from political risk)

    Planning Suggestion: If a married couple (Spouse A and Spouse B) are considering a gift of $10 million, "conventional planning" might suggest they split the gift, and have each use up $5 million of their available lifetime transfer tax exclusion. However, if they do that, and the sunset occurs after 2025, or political changes lower the exclusion amount sooner, each spouse has used the available exclusion, and no further transfer tax-free gifts may be made. Alternatively, do not spilt the gift. Have Spouse A be the sole donor of the $10 million, using Spouse A's exclusion, and none of Spouse B's exclusion. If the sunset occurs, or the exclusion amount is reduced to $5 million, Spouse B has made no gifts, so Spouse B can give away $5 million – resulting in a total of $15 million of tax-free gifts by this couple. Problem: What if Spouse B dies not having used the available $5 million exclusion? Solution: Portability – Spouse B's unused exclusion ports to Spouse A – who now gets the $5 million DSUE (Deceased Spouse's Unused Exclusion) from Spouse B, and can use that to pass another $5 million free of transfer tax.

    Planning Suggestion: Consider use of the "SLAT" – the Spousal Lifetime Access Trust – where there may be concern about the sunset of the 2017 Act exclusion after 2025 – or its earlier reduction. Create a trust for one's spouse, fund it with as much of the federal transfer tax exclusion amount as desired, and do not elect the marital deduction. This will utilize the transferor-donor's exclusion, and be "protective" of it should the exclusion be reduced in subsequent years. The donee spouse could also create a SLAT for the donor spouse, but **caution:** be certain that the trusts are not reciprocal. If they are, there is the risk that they could be ignored as valid transfers, with neither spouse being deemed to have made any transfer at all. In the event of the death of the donee spouse, and the passage of the trust property to children, consider obtaining a life insurance policy on the life of the donee spouse for the benefit of the donor spouse, preferably owned in an irrevocable trust. Consider including a provision in the SLAT allowing an independent trust protector to add as a beneficiary a descendant of the trust grantor's grandparents – as a future protection of the grantor's interest in the trust if the spouse dies or files for divorce.

Planning Suggestion: Utilize the gift tax exclusions, including the annual exclusion of $15,000 in 2020, Code Section 2503(b), as well as the exclusions from gift tax for unlimited transfers directly to educational institutions for payment of tuition expenses and unlimited transfers to medical care providers for medical expenses. Code Section 2503(e).

12. Planning for children with disabilities and special needs

13. Planning for spendthrift children (incentive and disincentive trusts)

14. Planning for clients who own real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to possible state estate taxes)

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

16. Planning for nonresident aliens with assets in the United States or who plan to move to the United States

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

18. Planning to pay education expenses, including contributing to Code Section 529 plans

19. Identifying guardians for minor children, as necessary

20. Considerations arising with respect to eldercare planning

    a. Making certain that appropriate durable powers of attorney and health care directives are in place. (This planning consideration is appropriate not only for elderly clients, but for all clients). In light of the sudden illness of so many people due to the Covid-19 virus, this planning has taken on a newly-recognized importance for all people.

i. Consider more specific directives with respect to gifting to protect against possible elder abuse.

ii. Warn the power holder about not giving away during lifetime assets that have substantially appreciated so that those assets will receive a basis step-up at death.

iii. Consider some directions about accessing digital assets in the event of incapacity or death.

b. With the demographic shift in the population and the aging of the baby boom generation, eldercare planning will take on a much greater significance. Planners should expect questions about when social security benefits should commence or be deferred and managing appropriate social security benefit strategies.

c. Long-term care insurance will be an eldercare concern of many clients, as will timely application for Medicare benefits and consideration of Medicaid eligibility.

IV. Portability Must Be Addressed by Every Married Person

A. Why Portability?

The primary motive for enacting portability of the federal estate tax exemption was simplifying estate planning for married couples. However, what often appears as simple may have a number of serious decisions associated with it. An issue all clients will face at all levels of wealth is whether to make the portability election at the death of the first spouse. Choosing to file a federal estate tax return (Form 706) and thereby making the portability election will be preferable in most cases. Reg. 20.2010-3(a)(3). Form 706 is required to be filed only when a decedent's estate exceeds the applicable exclusion $11,580,000 in 2020).

The assets of the decedent must be valued in any event for income tax basis purposes. The portability regulations allow a relaxed reporting procedure (when a return is not required to be filed but is filed for the purpose of taking advantage of portability) for filing the required federal estate tax return. It is only necessary to list assets and their estimated approximate values and then add $250,000, rather than listing and supporting (with appraisals, for example) the values of each of the assets. Completing Form 706 will not be overly onerous and should not be especially expensive for the average client. If an estate tax return is not filed to make the portability election, the planner will want to obtain a waiver letter signed by the executor (and perhaps the beneficiaries) exonerating and indemnifying the planner from any future responsibility arising from the failure to make a portability election.

If a federal estate tax return is required to be prepared in a decoupled state in connection with the filing of the state estate tax return, the incremental cost of filing the federal return will be even less onerous. The American Tax Relief Act of 2012 made portability permanent, and the 2017 Tax Cuts and Jobs Act did not disturb portability. The law allows portability of any unused applicable exclusion amount for a surviving spouse of a decedent who dies after 2010 if the decedent's executor makes an appropriate election by filing a timely federal estate tax return that computes the unused exclusion amount. The unused exclusion amount is referred to as the *deceased spouse's unused exclusion*, or the "DSUE amount." The surviving spouse can use the DSUE amount either for lifetime 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.

<u>Example 1</u>: A and B are married. A dies, leaving all of A's property to B. Form 706 is filed at A's death. B gets the DSUE as A's surviving spouse. Now B marries C (who had been married to D). B can still use the DSUE from A for gifting or at death, as well as B's own applicable exclusion. B and C can also utilize C's applicable exclusion, and possibly D's applicable exclusion if C had received any DSUE from D.

<u>Example 2</u>: Assume in the previous example that C dies while B is still living. Now, C is B's last deceased spouse. Any remaining unused DSUE that B obtained from A is now lost, since A is no longer B's last deceased spouse. If Form 706 is filed for C's estate, B may now obtain DSUE from C if any is available. If C has no DSUE (perhaps C left the exclusion amount to children of a prior marriage), B has no DSUE available, and is limited to B's own applicable exclusion. Reg. 20.2010-3(a)(3).

There is a "use it or risk losing it" point to be made here. Gifts made by a surviving spouse will first use the DSUE amount from the last deceased spouse before using the surviving spouse's own basic exclusion amount. Reg. 25.2505-3(b). If there is a subsequent marriage, the DSUE from the first deceased spouse remains available as long as the most recent spouse remains alive. If the second spouse dies, the unused DSUE of the first spouse is lost.

Every estate of a deceased married person should consider making a portability election. Even if the family assets are significantly below the federal estate tax filing threshold, it is possible that a windfall through good fortune or inheritance could occur in the future to increase a survivor's estate. The survivor could remarry a significantly wealthier person, making the DSUE of the deceased spouse a valuable asset. Perhaps the "new" spouse will be generous to the family of the DSUE holder. The survivor could sustain an injury leading to an unanticipated but significant financial recovery.

The IRS announced in Rev. Proc. 2014-18 that a late Form 706 could have been filed to make the portability election for persons who died after December 31, 2010, as long as the form was filed by December 31, 2014. This late filing opportunity was not extended in the final portability regulations (Treasury Decision 9725, June 12, 2015). Instead, taxpayers who failed to make the election and now wished to do so had to request a private letter ruling and pay a $10,900 user fee to be granted an extension of time to file the election.

Since the end of 2014, hundreds, if not more, private letter ruling requests were filed (and granted) under Reg. 301.9100-3 to extend the time to make a portability election where the decedent's estate was not otherwise required to file Form 706. Since the interests of the IRS would not be prejudiced by a late Form 706 filing and late portability election in such cases, relief was typically granted. See, for example, LTRs 201725011, 201725013, 201725016, 201725018-201725021, 201725023, 201723025 (June. 26, 2017).

The IRS then issued Rev. Proc. 2017-34, IRB 2017-26 which provides a simplified method for estates of decedents that are not otherwise required to file Form 706 under Code Section 6018(a) to obtain an extension of time to file Form 706 and elect portability, assuming certain criteria are satisfied.

The taxpayer must be an executor of the estate of a decedent who was survived by a spouse who died after December 31, 2010 and a U.S. citizen or resident at the time of death. A complete and properly prepared Form 706 must then be filed on or before the second anniversary of the decedent's date of death. The words, "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER 2010(c)(5)(A)" must be written at the top of Form 706. Assuming these requirements are met, relief will be granted to extend the time to elect portability, <u>without</u> the need for a private letter ruling and payment of the user fee.

If a taxpayer does not meet the above requirements for relief, the estate can still request an extension of time to make a portability election by requesting a letter ruling and paying the required user fee. If a taxpayer had a letter ruling request pending on June 9, 2017 and the estate is within the scope of the Revenue Procedure, the ruling request file will be closed, and the user fee will be refunded.

B. Simple Wills Are More Likely to Be Favored Now—Is That the Right Call?

With the portability provisions having been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning (the "I Love You" will), relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. Is that the correct decision from the planner's perspective? The lure of simplicity through portability and reduced planning costs may in some cases make the planning process more complicated to communicate fully to clients the advantages and disadvantages of planning alternatives. The advantages of simplicity and a potentially stepped-up income tax basis at the surviving spouse's death may be a hard combination of perceived advantages to overcome.

C. Why Still Consider Using a Bypass Trust at the First Spouse's Death in a Portable World?

The DSUE amount is not indexed for inflation. Is there concern about long-term appreciation between the first and second deaths? The bypass trust protects the surviving spouse's estate from being taxed on appreciation between the first and second death. If there has been appreciation that still leaves the survivor short of the federal estate tax threshold, consider using a trust and giving an independent person, such as the trustee or a trust protector, the right to grant the surviving spouse a general power of appointment over the assets in the bypass trust to force their inclusion in the estate of the last spouse to die, thereby gaining a basis increase with no estate tax liability.

Growth in the assets in a bypass trust is excluded from the estate of the survivor. Growth is not excluded from the gross estate of the surviving spouse where assets are received outright, or if they pass to a QTIP trust for the surviving spouse's benefit. (Code Sections 2033, 2044).

There is no portability of the GST exclusion. A bypass trust at the first death of a member of a married couple passing ultimately to skip persons can secure the benefits of the first decedent's GST exclusion, leaving the survivor able to use his or her own GST exclusion in the future.

There is an unlimited statute of limitations on values for purposes of determining the DSUE that begins to run from the time the first deceased spouse's estate tax return is filed. Reg. § 20.2010-3(d); *Estate of Sower*, 149 T.C. No. 11 (Sept. 11, 2017). Recordkeeping must be maintained until the second spouse dies and that spouse's estate tax issues are resolved. The unlimited statute of limitations applies only to the proper calculation of the decedent's DSUE amount. The federal estate tax liability of the decedent's estate cannot be reopened once the standard statutory three-year statute of limitations has run. The statute of limitations does run on values if a bypass trust is funded at the first spouse's death. Code Section 6501(a) requires the IRS to assess an estate tax liability within three years after the filing date (or due date, if later) of the estate tax return. The statute of limitations on assessment of estate tax cannot be extended.

The DSUE of the first spouse is lost if the surviving spouse remarries and the new spouse predeceases the surviving spouse. If the second deceased spouse leaves behind little or no unused exclusion, the surviving spouse has missed a potentially valuable opportunity. The surviving spouse can use the DSUE of the first deceased spouse for lifetime gifting, so long as there is not another deceased spouse (who then becomes the "last" deceased spouse and replaces the earlier deceased spouse as the potential provider of DSUE to the survivor) and the ordering rules provide that the DSUE is used by the survivor before the survivor's own exclusion. Reg. 25.2505-2.

The state exemption amount is not portable (except, to date, in Hawaii and Maryland, which have made their state estate tax exclusions portable). In a decoupled state, the client may, as a minimum, want to fund a bypass trust with the amount of the available state death tax exclusion to be sure it is used at the deaths of both spouses.

A bypass trust could be funded with aggressively discounted hard to value assets when there may be a low audit risk at the first spouse's death where there is no federal tax liability. That may lock in that valuation once the statute of limitations has expired.

The use of a bypass trust can avoid unequal treatment that might otherwise occur in a blended family situation (where at least one spouse has children by a prior marriage). The presence of a blended family situation may be one of the more compelling reasons to advise a client to consider planning that is somewhat more complex, but essentially more protective of family members. Many clients are in blended family situations. According to statistics, www.pewsocialtrends.org/2011/01/13/a-portrait-of- stepfamilies/, more than 29 million parents (13 percent) are also stepparents to other children, and 40 percent of married couples with children in the United States are step-couples. In such cases, at least one partner has a child from a previous relationship; this includes full and part-time residential stepfamilies and those with children under or over the age of 18.

> In a blended family situation, substantial inequities may result if the credit shelter approach is not used. 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 simply refuse to make it. The executor may be unwilling to bear the expense of filing an estate tax return to make the election. (Where this may be a concern, consider drafting the will 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). If the survivor has children of his or her own, they become the more likely beneficiaries where the spouse is entirely free to act. If the survivor remarries, there is the risk that the new spouse will benefit from the decedent spouse's property.
>
> The first decedent may use a QTIP trust to control the ultimate disposition of the property. However, 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. For example, that spouse could request and receive principal distributions from the trust, or make large lifetime gifts using the DSUE amount of the first spouse to die, leaving no exclusion amount to apply against the marginal tax generated by the QTIP, or could gift the income interest (treated as a transfer of the entire QTIP property per Code Section 2519) or be entitled to a substantial estate tax reimbursement at the second death if there is a taxable estate which then includes the QTIP trust assets under Code Section 2207A—even though the assets are "protected" in a QTIP trust.
>
> Consider using a premarital or post-nuptial agreement in which the parties agree that the surviving spouse will make certain that the decedent's executor makes the portability election. Trusts provide a variety of important benefits, including asset protection, management, and restricting transfers of assets by the surviving spouse (although those benefits can also be utilized with portability by using a QTIP trust rather than a bypass trust). The client should consider carefully whether the surviving spouse is capable of managing assets. Is there fear of the spouse's remarriage or a concern about undue influence? Spendthrift provisions, providing that trust beneficiaries cannot sell, pledge, or encumber their beneficial interests in the trust, should be included as a protection against

creditors. The possible future incapacity of a spouse or descendant can be addressed through a trust. If appropriate, special-needs provisions can be asserted to guard against the trust assets being used for payments that could otherwise come from public assistance.

D. Some Planning Situations Favor the Use of Outright Transfers to the Spouse and Reliance on Portability

There are several instances in which the use of outright transfers to the spouse may apply, including the following:

- The client insists on a strong desire for simplicity and wants nothing to do with any trusts.
- The spouse is an entirely competent individual who can manage assets capably.
- The spouses are in a first and only marriage, or it is not a first marriage but there are no children existing by a prior marriage of either spouse.
- The clients indicate much more interest in securing a basis step-up than getting future appreciation out of their estates, especially if they believe that any such appreciation will still leave them well short of the applicable exclusion amount.
- The clients own a residence or other assets that would be difficult to administer in a trust.
- The additional administrative and income tax costs of having assets in trust, such as the additional income tax and net investment income tax that may apply to undistributed trust income, outweigh the potential tax and non-tax advantages of trusts. In 2020, trusts with income in excess of $12,950 have that income taxed at the highest tax rates (37% in 2020) and have the 3.8% net investment income tax apply over the $12,950 threshold—a threshold substantially below the threshold that individuals, whether single or married, must address. (For 2020, the 37% rate is reached at $518,400 of taxable income for single filers and at $622,050 for married persons filing jointly and these thresholds are indexed for inflation). (The 3.8% net investment income tax becomes payable when single filers exceed $200,000 of adjusted gross income, and married persons filing jointly exceed $250,000 of adjusted gross income. These thresholds are not indexed for inflation).

V. Income Tax Planning—The New Essential Planning Focus

A. Income Tax Planning Will Replace Transfer Tax Planning as a Primary Focus

Income tax issues will overtake transfer taxes as the primary area of planning concern for persons of moderate wealth in an effort to minimize current income taxes and maximize the basis step-up available on death. For those clients domiciled in non-estate tax states, which are states that are not decoupled from the federal estate tax, income tax considerations will totally replace estate taxes as the tax planning focus of estate planning.

A key issue for these clients will be preserving a step-up in basis at the death of each spouse. For many clients, a potentially higher capital gains tax in the future, resulting from loss of a second basis step-up for assets that might be held inside a bypass trust, may be an unacceptable choice. The potential 20 percent federal capital gains tax, supplemented perhaps by a 3.8 percent net investment income tax, and possibly state income taxes, could result in some clients facing a capital gains rate approaching or significantly exceeding 30 percent..

A simple will or revocable trust leaving all of the assets outright to the surviving spouse will achieve a basis adjustment at the deaths of both spouses.

If a trust is desired for blended family protection or for management or asset protection purposes, or for protecting the surviving spouse financially, but denying the surviving spouse ultimate control over the property, using a QTIP trust will allow a basis adjustment to take place at the surviving spouse's death.

This planning is sometimes referred to as the use of the "portability QTIP", i.e. a QTIP trust used to take advantage of the marital deduction so that the available exclusion of the decedent is not used, allowing the portability rules to move the decedent's DSUE to the surviving spouse. In such a situation, where the decedent's estate is below the applicable exclusion, use of the QTIP is not really "necessary," since even absent to use of the marital deduction, there would not be any estate tax imposed. Some planners expressed concern that the IRS could invoke Rev. Proc. 2001-38, which had suggested unnecessary QTIP elections could be held invalid. This concern was alleviated when the IRS issued Rev. Proc. 2016-49, IRB 2016-42 (September 27, 2016). Here, the IRS declared that it would allow QTIP elections to be deemed valid even if the election was not necessary to eliminate estate tax liability, setting aside Rev. Proc. 2001-38.

Lifetime gifting of appreciating assets may no longer be recommended as a planning technique. For persons of moderate wealth, it will be more advantageous to retain appreciating assets and leave them to heirs, thereby passing on to heirs the highest tax basis at death. Code Section 1014. Had the assets been given away during one's lifetime, the basis to the donees would be the carryover basis of the donor, (Code Section 1015) most likely leading to more capital gain and net investment income tax liability for the donees.

Planning Pointer: Consider the planning suggestion of "upstream planning." This involves transferring low basis assets to an elderly family member (E) with the expectation that E will die, have the assets included in E's estate (be sure E will not have a taxable estate) and the assets will return to the donor with a basis equal to the fair market value of the assets at the date of E's death. If E lives more than one year from the date of the transfer, the donor will receive the property with the fair market value basis as of E's date of death. If E fails to live more than one year, the property returns to the donor with no basis adjustment from the donor's original basis. Code Section 1014(e). To guard against E's death within one year, consider having E leave the property to the donor if E survives more than one year from the transfer, and to the donor's children (or others) if E does not live beyond one year. Since only the donor is affected by the "return of basis rule," passing the property to others, even if there is a death within one year, will give the recipient a basis equal to the fair market value of the property at E's date of death.

B. New Planning Considerations Will Focus on Income Tax Issues

A very significant part of the value of the moderate wealth client's estate presently consists of appreciated assets. Since these assets will not be subjected to transfer tax, the avoidance of both capital gain taxes and net investment income taxes and passing assets with a stepped-up basis becomes a primary concern. Traditional estate planning techniques used to reduce the value of assets on death, such as family limited partnerships and limited liability companies formed to create valuation discounts for estate tax savings, may be counterproductive to planning in the current planning environment.

In a sense, estate planning is upside down from what has been traditionally favored. For persons of moderate wealth below the federal estate tax exclusion, the goal of planning is to now include everything possible in an estate at maximum value. This is quite a change from the traditional notion of exclude as much as possible, and minimize the value of whatever must be included.

This change in thinking must be embraced not only by the client, but also by the planner who must guide the client. It is an essential consideration in much of what must be done to plan estates effectively in the post-2017 Act world. Practitioners have fought for many years to maximize valuation discounts for lifetime gift transfers and for the value of interests in any assets included in a client's estate. A key component of the documentation of many gift plans, and estate tax returns, has been the formal appraisal of the discount applicable to the non-controlling interest in an asset or entity involved. The IRS has resisted these discounts and often challenged them as excessive. With the majority of clients no longer facing a federal estate tax, claiming valuation discounts will provide no estate tax benefit whatsoever, but will reduce the value of the basis step-up and thereby increase the future capital gains costs the client's heirs will face.

Accordingly, creating asset transfers that generate significant discounts may no longer be desirable. Claiming discounts on transfers at death for minority interest or lack of marketability will only serve to reduce the value of property inherited by heirs from a decedent, and the basis of that property to the heirs. Where there will not be any federal estate tax at the decedent's death, such discount claims are counter-productive.

It is possible that the practitioner and the IRS will reverse roles in these situations, with the practitioner arguing for lower (or no) discounts. This issue actually may favor the taxpayer, since if an estate is well below the taxable threshold for federal estate tax, it may not be reviewed carefully, if at all by the IRS. Where that is the case, the IRS will not be in a position to challenge the taxpayer's value as too high and argue that a discount should be claimed.

Consider whether there are provisions in the governing documents of an entity (such as a partnership agreement for a partnership, shareholders' agreement for a corporation or operating agreement for an LLC) that were crafted to allow or encourage discounting (such as minority interests, preferred issues, or below fair market value puts and calls). Where these are present, consider amending the governing document to minimize or eliminate the discounting opportunity.

This planning fix may not be as simple as it appears, since such a suggested revision may not be agreeable to other members of the entity involved if their estates are large enough to face a federal estate tax. It is possible that some, but not all of the members of the entity reside in a decoupled state where the discounting opportunity would be favorable. In making any changes to the governing document, consideration should also be given to not reducing asset protection benefits or taking away important non-tax considerations, such as a right of first refusal to keep a family asset in the family.

The current planning environment for persons of moderate wealth will give rise to a new approach to appraisals of property owned by a decedent. Nothing will change for persons whose estates are over the federal estate tax exclusion—they will continue to seek appraisals to minimize values that will have the effect of minimizing federal estate tax (and state estate tax, if applicable). For those persons whose estates are under the federal estate tax exemption and who are domiciled in a state that does not have a state estate or other death tax, maximizing the valuations of all estate assets so long as the person's estate remains under the federal exemption will provide the decedent's heirs with the most favorable income tax basis or capital gains result at no estate tax cost. For those persons whose estates fall under the federal estate tax exemption and under their decoupled state's estate tax exemption, it makes sense to maximize the valuations of all estate assets so long as the person's estate remains under the state estate tax exemption. This will provide the decedent's heirs with the most favorable tax basis or capital gains result at no estate tax cost.

The most difficult issues will arise for those persons whose estates fall under the federal estate tax exemption but over their state estate tax exemption. What will be the marginal tax impact of the state estate tax compared to the possible capital gains tax savings that high values (and high income tax basis) will result to the decedent's heirs? The heirs may be in the 20 percent or 23.8 percent capital gains tax bracket (including the net investment income tax). The highest estate tax bracket for most states with a decoupled estate tax is presently 16 percent —except Washington and Hawaii, which have a top bracket of 20 percent. It may be intuitive to do everything possible (lifetime transfers or discounting) to reduce the impact of the immediate estate tax; however, the counterintuitive planning of maximizing values at death—especially looking at the likely state estate tax bracket compared to the federal and state income tax impact—may be the better long-term plan.

This latter consideration involves the planner in further issues, such as the likely disposition by the heirs of the assets owned by the decedent. Will they be immediately sold by the heirs, suggesting the capital gain tax saving is a primary consideration? Instead, will they likely be held long-term by the heirs, possibly for the duration of their own lifetimes, suggesting that saving transfer tax at the first death should be the primary consideration? Considerations of marginal tax rates, anticipated holding periods, whether tax-free conversion options exist (such as a Code Section 1031 tax deferred like kind exchange of real estate assets) will all have to be factored into the planning process.

Deciding to disregard discounts on transferred property will be a more difficult issue in decoupled states, where the value of property at death will have a transfer tax impact. Focus on transferring possibly discountable property such as minority interests in S corporations, limited liability companies, and family partnerships to family members in lower income tax brackets so that the ongoing income can be earned there. Where the kiddie tax is not a factor, this planning can have an immediate benefit, and where the kiddie tax is applicable, the law forces the child's income tax liability to be taxed at the rates applicable to the child's parents. Persons outside of the kiddie tax range may be in the 0–15 percent tax bracket for qualified dividends and capital gains on the sale of property.

However, this suggestion may introduce complication and possible objection into the discussion. Is the transferred property income producing so that it makes sense to transfer the income-producing potential to persons in lower income tax brackets? Conversely, is the property not especially income producing but of low basis to the donor, so that the donor's transfer of the property will deliver a low carryover basis to the donee with little income potential but a possibility of a substantial future capital gain? The latter is not the ideal plan in the current planning environment.

Another planning tool to consider in the quest for higher income tax basis adjustments is the Code Section 754 election. This election is available for partnerships and LLCs taxed as partnerships. When a partner or LLC member dies, his or her heirs receive the partnership or LLC interest of the decedent with a basis equal to the date of death value of such interest, according to Code Section 1014. That is the *outside* basis of the partnership interest. The basis of the partnership or LLC in its own assets (the *inside* basis) is not affected by the death of the partner or member. Accordingly, sales of low basis partnership or LLC assets will be taxable to the new heir partner—even though that person may have a high outside basis.

That is where the Section 754 election comes in. If the entity makes an election to have Section 754 apply, the inside basis of the decedent partner or member's share of the entity's assets is also stepped-up. This allows the heirs to apply the higher basis to the realization of the entity's income, and very possibly avoid income taxation. The partnership or operating agreement may provide for the 754 election to be made. If it is silent and planning suggests making it would be helpful to the heirs of any partner or member who dies, amend the appropriate agreement as soon as possible. This may be preferable to awaiting a death, then possibly having to negotiate making the election. Taking action before anyone dies may be the best strategy.

C. Special Planning Concerns Where Trusts Are Used

Even where trusts are favored for all of the reasons discussed (management, asset protection, and blended family concerns), retaining income within a trust is not a favorable planning decision. Due to the highly compressed income tax rates for trusts, trust income in excess of only $12,950 in 2020 is taxed at the highest marginal rate of 37 percent. The 20 percent marginal rate on long-term capital gains and qualified dividends is reached at $13,150, and $12,950 is the 2020 threshold for application of the net investment income tax). This suggests that distributing trust income currently can be tax advantageous.

Compare the compressed rate threshold for trust distributions to the thresholds for individual taxpayers—single persons reach the net investment income tax threshold at $200,000 of adjusted gross income and the 37 percent rate threshold at $518,400 of taxable income in 2020, and married persons filing jointly reach the net investment income tax threshold at $250,000 of adjusted gross income and the 37 percent rate threshold at $622,050 of taxable income in 2020. The 20% rate threshold for long-term capital gains and qualified dividends is reached in 2020 at taxable income of $441,450 for single filers and $496,600 for married persons filing jointly.

Although distributing income is a favored planning alternative, it may not always be an available option. What does the governing instrument require with respect to distributions? What about state law? What does the governing instrument or state law say about the distribution of capital gains to any current income beneficiary? As a general rule, capital gains are defined as and allocated to trust accounting principal, and are not readily distributable to income beneficiaries. Does the trust contain a unitrust provision permitting distribution of capital gains?

In preparing new trusts, it is suggested that the trustee be at least given discretion to distribute capital gains to the income beneficiaries. For existing trusts, look carefully at state laws. Is there a "power to adjust" provision allowing a trustee to distribute capital gains if not strictly prohibited by the governing instrument? Is there authority granted to a trust protector or other fiduciary to modify the document to allow such distributions? If not, consider decanting the trust to a new trust with broader provisions that would permit inclusion of capital gains in trust income. With all of that said, however, planning should not lose sight of why a trust was created in the first place. Appropriate consideration must be given to any relevant non-tax factors that weigh against making a distribution, prior to distributing trust income solely to save income taxes.

D. Consider a Sprinkling Trust to Maximize Income Shifting Opportunities

A marital deduction qualified trust (QTIP or general power of appointment) must, of course, limit income distributions exclusively to the surviving spouse. Where a trust is created that is not a marital deduction trust (a bypass trust or any other trust desired by the grantor), consider including a broad list of current or permitted beneficiaries—possibly all of the descendants of the creator of the trust. This may provide trustees who are given the appropriate discretion to make distributions a larger pool of potential distributees in lower income tax brackets.

Where appropriate, think of each permitted beneficiary as a bucket to be filled from the trust without exceeding the thresholds of the lower tax brackets of these beneficiaries, with the goal of minimizing the overall impact on the family's income taxes. Tax planning is not the only issue here. Are current distributions by the trustees to selected beneficiaries appropriate? Will the beneficiaries be honest in reporting their income situation to the trustees? How will the beneficiaries behave if some receive more generous distributions from the trust than others? View the income distribution opportunity as just that—an opportunity, not an absolute requirement created by otherwise adverse tax laws.

E. Take Advantage of the 65-Day Rule for Complex Trusts

An election is available under Code Section 663(b) to have an amount paid or credited to a beneficiary within the first 65 days of a tax year to be treated as if paid or credited during the estate or trust's prior tax year. This election gives the trustee the opportunity to use information as to the income status of all beneficiaries for the prior year in planning a distribution to minimize overall family tax burdens.

This election can be used in a number of helpful planning situations, such as shifting income to a lower bracket taxpayer, shifting income to avoid an underpayment of estimated taxes by the trust, or moving income to a beneficiary to take advantage of a beneficiary's net operating loss or excess capital loss.

Most if not all of the income of a trust will be net investment income subject to the 3.8 percent tax when the 2020 threshold of $12,950 is passed. Therefore, the trustee may consider taking advantage of the election to make income distributions in order to reduce the trust's exposure to the net investment income tax.

The 65-day election is made by checking the required box on Page 3, Other Information, Line 6 of Form 1041 for the trust (or estate, if applicable).

F. Take Advantage of a Section 529 College Savings Plan

The advance funding of five years of Code Section 529 plan contributions— that is, the permissible making of five years of annual exclusion gifts to a Section 529 plan in the current calendar year with no detriment for gift tax purposes—has long been used as part of a gift strategy to shift assets out of the donor's taxable estate. If the donor dies within the five-year period, there is a recapture and inclusion in the donor's estate of all or a portion of the gifts made for transfer tax purposes, representing the "unused" years of the gift tax present interest exclusion. Otherwise, the Section 529 plan holder is not subject to estate tax inclusion. For those persons who will not face a federal estate tax, the potential recapture is of no consequence. However, with the gifted assets earning tax-deferred or excluded income within the Section 529 plan, there are many years of potential income tax savings available here. This makes the Section 529 contribution all the more appealing in the current planning environment.

The 2017 Tax Cuts and Jobs Act allows funds in a Section 529 plan to be also used for K-12 expenses for public and private school students (up to $10,000 per student per year). The Act also permits funds in a Section 529 plan to be transferred to an ABLE Act plan if the beneficiary is disabled.

VI. What Should Be Done with Life Insurance?

A. Why Was Life Insurance Acquired?

Persons of moderate wealth will no longer need life insurance to fund federal estate tax liability. If that was the only reason life insurance was acquired, and if the client sees no other benefit in retaining it, the client may opt to cancel the policy.

If life insurance was acquired for more traditional planning reasons, such as payment of death-related expenses or financial security for heirs or education funding, and its central focus was not just to be a source of death tax payment, then it remains a viable asset for the purposes acquired. Of course, if the traditional reasons have changed, the planner should explore the continued viability of life insurance with the client.

B. The Role of Life Insurance in Any Estate Plan

Life insurance is an asset possessed by virtually all clients to some extent. Assume that there is no need to retain life insurance to pay federal estate tax liabilities. What should be discussed with the client as to the ongoing role of life insurance in an estate plan?

The core reasons that most persons acquire life insurance never included using it as a source of tax payment. Tax payment was always a secondary objective, and one more appropriate for high net worth families, not families of moderate wealth. The post-ATRA planning world has not changed the reasons most people acquire life insurance, which include the following:

- To create an estate for the financial support and security of a family in the event of premature death.
- To provide financial support for a surviving spouse and educational funding for young children.
- To provide a readily available source of liquidity to pay debts, address funeral and administration expenses, fund bequests, and, where necessary, fund buyout agreements and other possible contractual obligations.

There may be a need to preserve permanent life insurance to pay for state estate tax liabilities for those clients domiciled in decoupled states. This may not be a strong motivating factor for clients who may argue that a surviving spouse may move to a non-decoupled state, or that the state of current domicile may eliminate its estate tax. Some clients may decide that life insurance is the easy way to pay for state estate tax liabilities without doing other more complex planning and maintain a policy for this purpose.

Others will embrace the concept of comprehensive planning to avoid state estate taxes and decide that life insurance protection for this purpose is not necessary.

Despite the client's best efforts to engage in comprehensive planning, it is possible that not all assets owned by a decedent will achieve the optimal basis step-up. In such a situation, life insurance policies benefitting the client's children may be used to pay for the income tax cost the children will bear when the low basis assets are acquired by them and subsequently sold. Perhaps ordinary income assets representing income in respect of a decedent (such as retirement plan assets) will be inherited. It may be advantageous for non-tax reasons to gift some low basis assets during lifetime and accept the carryover basis result. The life insurance payable to the heirs at death can provide a source of income tax payment (or wealth replacement) if these assets are liquidated. Planning may have favored a bypass credit shelter trust for a surviving spouse that resulted in a basis step-up at the first death, but not at the second death when the children inherit property still bearing the first decedent's date of death basis. The future sale of the trust assets by the children may result in capital gains to them.

Life insurance can be used to provide direct bequests to children from a prior marriage. This may satisfy the client's desire to provide for children without having to address the blended family concerns of trusts or dividing assets between the current spouse and the children of an earlier marriage. Insurance left to the children so that the balance of the insured's estate can be left outright to the surviving spouse or others may be advisable both to maintain simplicity and achieve a full basis step-up for the assets passing to the spouse or other beneficiaries.

Consider recommending the acquisition of additional life insurance as an excellent income tax shelter. The build-up of cash value within a permanent life insurance policy is not considered net investment income and is not taxable to the policy owner. For the client in a high income tax bracket unconcerned about federal estate taxes, the favorable income tax treatment of life insurance (the tax-free build-up of cash values and the ability to access that cash value in a tax-advantaged manner through policy loans) may become an attractive planning option.

Access to cash values within a life insurance policy is possible even if the policy is held in an irrevocable trust, assuming the trust is properly drafted. Language can be included in an irrevocable trust authorizing an independent trustee to borrow the cash value and distribute it to the trust beneficiaries. Such distribution will be income tax free to the recipients. If one spouse is the insured who creates the trust and the other spouse is the primary trust beneficiary, the borrowing and distribution by the trustee can be for the benefit of the beneficiary spouse—with the insured spouse having no adverse tax effect from the availability of funds to the marital relationship. PLRs 9748029, 95451053. So long as the withdrawals do not exceed the income tax basis in the policy based on the premiums paid by the insured, withdrawals to the extent of the income tax basis are not subject to income tax. If additional cash is needed beyond the income tax basis, such cash should be withdrawn as policy loans to avoid income tax implications. For these income tax rules to apply, the policy must not be characterized as a modified endowment contract and should not be surrendered. Should the insured die with the policy in force, any cash value above the income tax basis not previously withdrawn is also not subject to income tax, even if the policy is then characterized as a modified endowment contract. Code Section 101.

With the concern about the federal estate tax alleviated for the moderate wealth taxpayer, there is less reason to feel compelled to transfer a life insurance policy to an irrevocable trust. Retaining ownership of the policy allows the policy owner to access policy features such as long-term care riders or other benefits, and to withdraw cash values as needed without having to look to trustees or strain the language of a trust to secure a withdrawal from the policy.

As many life insurance sales persons are quick to point out, compare the return generated by a permanent life insurance policy with other investment returns realized by a client through his or her investment portfolio. The insurance policy return has exceeded interest rate returns on bank and money market funds, is often favorably compared with average dividend yields, and, depending on investment performance, may be favorably compared with the client's portfolio growth. Certainly acquiring or retaining some life insurance as part of a person's investment profile is a good hedge against the volatility of other investments.

C. Use Life Insurance More Aggressively in Planning

Consider the situation of a client who created and owns a successful business. Planning prior to the 2017 Act may have suggested giving away pieces of the business during lifetime to avoid federal estate tax on appreciation and to secure minority interest and other discounts as the gifts are made. Now, consider leaving the business in the hands of the owner to assure a stepped-up basis on death, especially if it is likely to be retained by the surviving family members. To protect against any possible state estate tax, have the client acquire a life insurance policy that could be used, if necessary, to cover the state estate tax liability, allowing the business interest to pass easily to the intended beneficiaries.

Similar considerations favoring life insurance ownership would apply if the asset owned by the senior family member was appreciated real estate, rather than a business interest. Where family business succession planning is a potentially difficult issue if one family member is an appropriate successor to the business interest and other family members are loved equally but not seen as appropriate business successors, using life insurance to equalize benefits among heirs becomes an even more attractive option when the life insurance proceeds left to heirs will avoid estate tax. The business interest can be held until death, thus assuring a date of death basis to the heir and be specifically bequeathed to the intended beneficiary. If other children are residuary beneficiaries of the estate and named beneficiaries of life insurance policies, there is a greater likelihood that equalization among beneficiaries can be achieved absent concerns about who inherits a family business interest and whose share of the estate will be reduced through transfer tax payments.

D. What Should Be Done With Life Insurance Trusts?

If the client's estate is approaching the level where state or federal estate tax liability is becoming a possibility, an irrevocable trust to hold life insurance policies and remove them from the taxable estate remains a viable planning option. If the traditional non-tax reasons for using a trust are present, an irrevocable trust to hold life insurance policies remains an excellent planning tool. Life insurance is typically an easy asset to persuade clients to gift, since they do not see themselves enjoying the benefits of the proceeds of the policy, and absent a cash need, generally do not plan to withdraw the cash value. There is no carryover basis or basis step-up issue for a life insurance policy, so there is no detriment in giving it away during the client's lifetime.

In smaller estates, consider whether there is appropriate justification for a life insurance trust. There are legal, administrative, and tax return preparation costs associated with a trust that may not be necessary. Absent the need for the protective benefits of a trust, consider just giving the life insurance policies to heirs while the insured is alive. The insured can keep making premium payments as an annual gift, but the policy will be removed from the insured's estate along with any issues of probate, potential claims of the estate's creditors, and the costs and administrative burdens of dealing with the policy after the insured's death.

The clients may have purchased survivorship life insurance and placed the policy into a trust. The purpose of the insurance was most likely to have a fund to pay federal estate taxes at the second death of a married couple. In light of the increased applicable exclusion and portability, the survivorship life insurance policy may no longer be needed for tax payment purposes. What should be done with the policy and the trust that holds it?

One answer would be to cancel the policy and have the trustee receive the cash value and administer it in accordance with the terms of the trust. That is an easy solution to suggest—but attention must be paid to the terms of the trust and the responsibilities of the trustee.

Other options might be to consider a tax-free exchange of the policy under Code Section 1035 for a qualified annuity or another insurance policy that could offer more attractive terms (such as faster cash value build up that can be withdrawn or a payout at the first death of a married couple) than the second-to-die policy offers. Alternatively, keep the existing policy but stop paying additional premiums and make the policy a paid-up policy based on the premiums paid to date.

Consider the status of the life insurance policy in the context of the annual administrative ritual of the trustee's receiving the premium notice, receiving a check from the insured, and addressing the annual *Crummey* notice issues. Assuming the client followed the correct *Crummey* notice procedures, is it necessary to continue to do so? In the worst case, an insurance trust will omit all references to rights of withdrawal and *Crummey* powers. Here, the premium payments by the insured will be viewed as future interest gifts, and a gift tax return will be required to be filed. Given the applicable exclusion and portability, the typical client will never have to pay gift tax or other federal transfer tax, so dispensing with the "*Crummey* dance" may be administratively favored with no adverse tax consequences.

If there is a desire to respect the *Crummey* withdrawal opportunity and avoid the gift tax return filing, consider a written waiver of all future withdrawal rights. *Turner v. Commissioner,* T.C. Memo 2011-209. Alternatively, it has been suggested that the client sign a one-time waiver stating that all *Crummey* rights in the future need be only given verbally. If this is done, be sure the trust document permits notices to be given verbally. Although these alternatives may not have the blessing of established law or IRS guidance, it can be argued that these suggestions are reasonable compliance with the *Crummey* procedures—and perhaps most importantly, if there will not be any transfer tax issues, no one will ever have to address any of these issues. Another suggestion could be to fund the trust with enough cash to pay the annual premiums for a number of years and ignore the present interest gift tax concerns that the *Crummey* power is intended to address. If transfer tax will not be an issue for the client, the "excess" gift to fund the trust (over the annual gift tax exclusion amount) will not prove to be a problem.

Include provisions in a life insurance trust to have it classified as a grantor trust. If the trust will own assets other than cash and life insurance, being deemed a grantor trust will allow the tax-free substitution of properties. Even if the trust will hold only life insurance, grantor trust status is still desirable as the trust will not be subject to the transfer for value rule if there is any transfer of the life insurance policies, even if the transfer is made for consideration. Rev. Rul. 2007-13, IRB 2007-11, 684; PLRs 200518061 and 200514001. A substitution power may allow the grantor to remove the policy from the trust in exchange for its then fair market value in cash, and redesignate beneficiaries in a new trust to remove the benefit of the future policy proceeds from a beneficiary who may have fallen out of favor.

VII. What Should Be Done with Retirement Plan Benefits?

A. General Considerations

The surviving spouse has always been the favored beneficiary of a decedent's retirement plans. A rollover of the decedent's qualified plan or IRA to a surviving spouse enjoys the marital deduction to avoid the estate tax (Code Section 2056) and special rules to defer the income tax on the roll over (Code Section 408(d)). Where possible, spouses have typically favored a distribution of a retirement plan to the surviving spouse to take advantage of these tax benefits. Under the SECURE Act, a spouse is an Eligible Designated Beneficiary, entitled to use his or her life expectancy for minimum required distribution purposes.

A problem has sometimes arisen in the larger taxable estates where the decedent's retirement plan is one of the major assets of the decedent's estate. In these situations, the only way to fund a bypass trust reasonably is to use the decedent's plan. When this is done, the applicable exclusion protects the plan from estate tax, but the inability to accomplish a spousal rollover results in immediate commencement of income taxation of the plan benefits based on the minimum distribution requirements for the oldest trust beneficiary.

Where the decedent's estate will not be subject to taxation, and portability will allow the bypass trust to be avoided, the recommended planning strategy would be to leave the retirement plan and IRA benefits directly to the surviving spouse to gain the advantages of income and estate tax deferral at the first death, and then to rely on portability to be able to utilize the deceased spouse's unused estate tax exclusion amount at the surviving spouse's subsequent death.

The IRS has eased the concerns about making certain that the rollover to the spouse occurred within sixty days of receiving the distributed funds with the issuance of Rev. Proc. 2016-47 (August 24, 2016). If the sixty-day rollover is not completed in a timely fashion, it may no longer be necessary to apply for a private letter ruling and pay a user fee to "fix" the problem. A person may self-certify that the 60-day period may be waived, and the IRS has issued a form letter to use in the process.

Three conditions must be satisfied for self-certification, namely, (1) there can be no prior denial by the IRS for a waiver, (2) the reason for the late rollover must be one of 11 reasons listed in the form letter, and (3) the funds must be redeposited in an IRA account as soon as practicable after receipt—30 days is indicated as a "safe harbor" here. The 11 reasons to allow self-certification include: financial institution error; misplaced check that was never cashed; deposit of the check mistakenly in an account believed to be an IRA account; damage to principal residence; death in the family; serious family illness; incarceration; restrictions imposed by a foreign country; postal error; distribution was made due to an IRS levy, now recovered; the distributing company did not provide information to the receiving company.

The IRS can audit a return and decide the self-certification is not appropriate, leading to the reminder to clients that the safest way to accomplish a rollover is always through a direct trustee-to-trustee transfer.

As in any recommendation of an outright transfer to a spouse, the issues addressed earlier regarding management, creditors, or blended families should also be considered in the context of a retirement plan distribution. Where the protection of a trust is desired, the retirement plan assets could be left to a QTIP Trust, but such a designation involves a fair amount of administrative and drafting complexity (Rev. Rul. 2006-26) and will most likely result in a faster required withdrawal of plan assets that will accelerate the income tax liability.

Distributions from a retirement plan are income in respect of a decedent, so there is no basis step-up when the decedent dies. The distributions are not considered net investment income, so they are not subjected to the 3.8 percent net investment income tax. However, the withdrawal of funds from a traditional IRA or qualified retirement plan account is taken into account in determining if the AGI and taxable income thresholds have been reached.

Attention must also be paid to the changes brought about by the SECURE Act of 2019. Regardless of the wealth or income tax bracket of a retirement plan beneficiary, the SECURE Act provides that life expectancy may no longer be used as the standard for minimum distributions from retirement plans for most beneficiaries. Instead, the Act provides for a required withdrawal within ten years of the year of death of the plan participant. The withdrawal may be taken in equal or unequal installments or at any time during the ten year time frame. Exceptions are provided to allow for minimum distributions over the life expectancy of surviving spouses, minor children of the plan participant, beneficiaries subject to disability or chronic illness and persons born within 10 years of the plan participant.

B. The Roth Conversion Opportunity

Consider converting a qualified plan or traditional IRA to a Roth IRA to both avoid having withdrawals be included in AGI (beyond the year of the actual conversion) and to avoid required minimum distributions if not needed. The stock market decline (of many stocks, despite the strength of the Dow rebound) as the result of the Covid-19 virus presents a special opportunity for Roth IRA conversions. With retirement plan balances reduced, with no required minimum distributions in 2020, and with the likely decline in many clients' overall income in 2020, this could be an ideal year to recommend a Roth IRA conversion. As the result of the 2017 Act, once the conversion is made, it cannot be recharacterized as a traditional IRA, but for those clients who are optimistic about the long-term recovery of the economy and stock market, and their own personal financial recovery – 2020 could present literally a once- in-a lifetime planning opportunity.

VIII. Changes in the Way Title to Property Should Be Designated

Before ATRA and then the 2017 Tax Cuts and Jobs Act significantly increased the amount of the lifetime transfer tax exclusions, planning for a married couple, especially in a common law state which does not enjoy the automatic split of marital property which is the law in community property states, always involved an uncomfortable discussion about how assets should be titled—ideally an amount of assets in the name of each spouse up to the amount of the applicable exclusion. This was recommended so that the estate of the first spouse to die could take full advantage of the funding of a bypass trust. If this was not done, and the spouse with less property died first, there would be a shortfall in the available exclusions over two deaths, since an insufficient amount of property was owned by the "poorer" spouse who had the bad fortune of being the first to die.

As the transfer tax exclusions grew in size, it became increasingly difficult (as well as burdensome and expensive) for many couples to retitle assets, such as real estate holdings and business interests. The spouse with the larger share of assets often was reluctant to retitle his or her holdings to the name of the less propertied spouse. Assets in joint names were recommended to be retitled as tenancies in common—a recommendation not always embraced by skeptical spouses. Even if there was willingness to make transfers, some assets could not be retitled, such as a business involving professional licenses or a family business with prohibitions on transferring interests outside the lineal family members.

Portability has made a great change here. Regardless of the title of assets at the first death, portability will grant the surviving spouse the deceased spouse's unused exclusion (DSUE) even if all of the family assets were titled in the name of the surviving spouse. There is no longer a federal estate tax-driven need to retitle assets to divide them between the spouses. That said, retitling at least to some extent may be useful and helpful to meet the state estate tax exclusion in a decoupled state or to make it easier to fund a credit shelter trust, if desired.

Title to property can now be used to address other important goals free of the tax-driven need to fund the bypass trust. Is one spouse an asset protection risk? Is a spouse involved in an activity where there is a possibility of malpractice or other liability claims? Where this may be the case, titling assets in the name of the lower risk spouse does not pose a tax problem where portability will preserve the DSUE of the first decedent, regardless of who is the property owner.

Controversy often arose about retitling assets that one spouse was gifted or inherited from his or her own family or brought to the marriage having earned or acquired them prior to the marriage. Where these assets were arguably safe from matrimonial claims of equitable distribution before retitling, changing the title suggested a gift and a withdrawal of the protection from separate property or equitable distribution claims. Portability makes these transfers unnecessary to gain a tax advantage. The tax advantage exists without the need for retitling.

Title to a person's home raises several issues that may be more easily addressed in the current planning environment. Property held jointly between spouses as tenants by the entirety generally is given preferential asset protection treatment under most state laws. The creditors of one spouse cannot reach the property while the other spouse is alive. The choice of retitling this property to gain the benefit of the bypass trust versus losing the asset protection benefit was often difficult. The combination of the increased applicable exclusion and portability allows the client to avoid making any change in the form of ownership here. What if the clients took the advice of the planner several years ago and removed a home from tenancy by the entirety status and conveyed it to separate tenancy in common ownership? It is suggested that the clients reconvey the tenancy in common property to joint names and reestablish the tenancy by the entirety asset protection if permitted by state law. Transfers between spouses bear no gift tax liability here.

Where a state offers special property tax and other benefits if a homestead exemption can be claimed, (Florida's homestead rules and California with Proposition 13 come to mind) not disturbing the title to property qualifying for such an exemption is generally a good idea. Some states (notably New York and California) have become especially aggressive in trying to extend the reach of their income taxes to persons who maintain a place of abode in those states, even if the persons are clearly domiciled elsewhere. Not having to be concerned about preserving a piece of title to property to qualify for federal tax benefits will allow persons to concentrate on issues such as domicile designations to make certain that they do not run afoul of aggressive state income tax rules.

Title considerations in jurisdictions outside of a person's true domicile may also trigger ancillary probate concerns. To avoid the cost and inconvenience of ancillary probate, consider owning such properties in a revocable living trust. That will avoid probate, but still gain the trust beneficiaries a date of death value as the basis when the trust grantor dies, because the property will be included in the deceased grantor's estate. Code Section 2038.

Did the client create a qualified personal residence trust (QPRT) that still has years to run? If the client has an ultra-high net worth and is likely to be a federal estate taxpayer, leave the QPRT alone. For the client of moderate wealth, however, having a QPRT may no longer generate any needed tax benefit. Instead, if the client successfully outlives the QPRT document's terms, there will not be any estate inclusion, and the heirs will take a carryover basis from the decedent. This may now be viewed as a detriment to family tax planning.

Consider having the client continue to live in or use residence without paying any rent, asserting a retained interest despite the QPRT document's terms once the term of use has expired. That will arguably place the QPRT property in the decedent's estate if retained at death under Code Section 2036. Have the QPRT beneficiaries acknowledge the retained interest. Alternatively, have the grantor purchase the residence from the trust. Or, have the beneficiaries exercise a prohibited commutation that will void the QPRT qualification. With no concerns about federal transfer tax liability, suggestions such as these to gain the potential basis step-up from estate inclusion are worthy of consideration.

Several caveats should be raised here. First, if the client resides in a decoupled state, be careful about suggesting more assets to be included in the client's taxable estate. Balance the impact of state estate tax imposition versus capital gains (and possibly state income tax) savings. It may be relevant for tax planning if the QPRT involves a residence that will be sold by the beneficiaries as soon as possible after the grantor's death (basis is then important), or a residence such as a treasured vacation home that is not likely to be ever sold (basis is then irrelevant). If a residence will qualify as the principal residence of someone—the gain exclusion of Code Section 121 may be available (if the two out of five year use and ownership criteria are satisfied) to avoid income tax concerns here. Consider the requirements of the trust, the obligations of the trustees, and the possible concerns of the beneficiaries. If the trustee is willing to act to break up the QPRT, be sure all beneficiaries of the trust are in accord, preferably by receiving an acknowledgement in the form of a written consent.

IX. Address the Status of Limited Liability Companies (LLCs), Family Limited Partnerships (FLPs), and Sales to Defective Grantor Trusts

In many cases, certain entities (LLCs and FLPs) were formed to remove assets from the transferor's estate and obtain a valuation discount in doing so. In the current upside-down planning world for the client of moderate wealth, the estate exclusion and the discount are both negatives.

The lifetime removal of the asset from the estate eliminates the basis step-up and may result in a very low carryover basis from the donor. The discounted value used in transferring the lifetime interest arguably also reduces the value of the asset at death—another limitation of the basis step-up. Over the last 20 years, there have been numerous cases litigated in the United States Tax Court addressing issues of whether retained rights and interests in family businesses should force inclusion in a decedent's estate. Perhaps taxpayers should look to the arguments raised by the government in these cases, and concede the government position is correct—and embrace it. File an estate tax return (non-taxable in the current world of portability and large exclusions) and concede the inclusion of the full fair market value of the enterprise in the decedent's estate.

Should the entity be dissolved? Possibly, but there may be appropriate non-tax asset protection, management and business identity reasons to continue the entity. Be careful with a dissolution, however. Bear in mind the rule in partnership transactions that the distribution to one partner of appreciated property contributed by another partner within seven years preceding the distribution will cause the contributing partner to recognize the pre-distribution appreciation, as if the partnership had sold the property at its fair market value on the date of distribution. Code Section 704(c).

Does the operating agreement or partnership agreement contain provisions that suggest discounting would be appropriate or necessary? If so, consider amending the agreement to remove those provisions so that the value on death will be fair market value, not a discounted value.

Consider if the operating or partnership agreement can be modified to assure inclusion of the value of the entire entity in the decedent's estate. Perhaps a retained right to income or controlling management powers can be used to force Code Section 2036 or Code Section 2038 to become applicable to the decedent's retained powers. In *Estate of Trombetta,* T.C. Memo 2013-234, the Court found an implied agreement where the decedent, having transferred property to an irrevocable trust, made all decisions with respect to the property, led negotiations in refinancing the property, and retained sole signatory authority in connection with disposing of the property. The Court found the trust property was includible in the decedent's estate despite the transfer to the irrevocable trust. Continued use of property despite its transfer may be sufficient to require estate inclusion. *Estate of Linderme*, 52 T.C. 305 (1969); Rev. Rul. 70-155, 1970-1 C.B. 189.

Evidence of continued exclusive use or enjoyment of property can suggest an implied agreement to retain an interest in the property despite its transfer to an irrevocable trust, and force an estate inclusion.
Estate of Thompson, 382 F.2d 367 (3rd Cir. 2004).

Consider accepting an argument sometimes raised by the IRS when a controlling interest is present to add a control premium to the price of a decedent's asset to increase the value (and the basis to heirs) when the decedent's estate falls below the applicable exclusion threshold. *Estate of Salisbury*, T.C.
Memo 1975-333.

If the client utilized the planning technique of the sale to the intentionally defective grantor trust, consider the client's federal estate tax status. If the client is expected to be a federal estate taxpayer, leave the defective grantor trust in place and have the client continue to pay the income tax and burn off potential estate taxable assets by doing so. (Rev. Rul. 2004-64, 2004-2 C.B. 7). If the client utilized the technique but is not likely to be a federal estate taxpayer, consider toggling off grantor trust status (relinquishing the powers that classified the trust as a grantor trust), especially if the income tax liability will then fall on persons in lower tax brackets, possibly below the thresholds for the highest income tax rates and the 3.8 percent tax on net investment income.

In either event, in the case of the intentionally defective grantor trust, whether or not the federal estate tax will be an issue, pay attention to the basis of the property the client used to sell to the trust. Absent further planning, the basis to the trust and to the trust beneficiaries is the carryover basis of the grantor, presumably a low income tax basis. If the grantor retained the power of substitution under Code Section 675(4) as the power to make the trust a grantor trust, have the grantor produce or acquire property (or use cash) of equivalent value to what is in the trust, have an independent trustee so certify, and use this power of substitution to exchange the properties. The trust and its beneficiaries will now have property with a current fair market value basis and the grantor will get back the property with the low basis. If the grantor holds the property until death and leaves it to the persons who are the trust beneficiaries, they will obtain a stepped-up basis in that property as well. Code Section 1014(a). Income tax on the appreciation will not be paid.

X. Planning for Persons in Decoupled States

A. More Difficult Considerations to Address

The family with moderate wealth may still have to address estate tax considerations if their state of residence is decoupled from the federal estate tax system and maintains its own estate or inheritance tax. Typically, the state exclusion is less than the federal exclusion, and the states other than Hawaii and Maryland (to date, at least) do not offer portability of their exclusions. Such a situation will require more complex planning if the family wants to take advantage of the available state exclusions.

Planning complexities may be compounded by the fact that some states will change their laws to either reduce or eliminate the taxes, and others may go in the opposite direction and institute a tax or reduce an existing exemption. Another complexity is the domicile of the survivor. If the survivor relocates to a state that does not have an estate tax, planning that was done may not have been necessary, or planning that was never done may be rewarded. Uncertainty rules here!

Planning in decoupled states suggests using a bypass trust at the first death to capture the amount of the available state exclusion so that it avoids taxation at both deaths. The advantage of this choice is the absence of state death taxation on the excluded property. Be careful of formulas here. If the formula used is to tie the amount of funding of the bypass trust to the full federal estate tax exclusion, the state estate tax liability at the first death could now approach $1 million under current law. If the formula is tied to and limited to the state estate tax exclusion, the state estate tax liability at the first death will be zero. The disadvantage of this choice to use the bypass trust at the first death is the lack of a stepped-up basis at the death of the surviving spouse and the possibility of future federal capital gain taxation at a rate higher than the state death tax rate.

The mathematics of all of this can become quite complex if time value of money issues are added to the analysis. When will the survivor die? When will property be sold? How much estate tax will be deferred? How much capital gain tax will be paid? These are all issues that can be addressed in these situations. Some clients are likely to reject planning for these complexities and opt for the more simplified and less costly planning suggested by the federal estate tax rules. Their attitude may be that if state taxes are due at the second death of a married couple, both spouses will be dead at the time, and let the children worry about it. They may say that if the surviving spouse lives long enough after the first death, state and federal laws may change dramatically or the survivor may relocate—so why spend a lot of money and planning anguish now when so much is unknown. Can it be said that they are wrong?

Other clients will object to paying any tax that is not absolutely unavoidable, so they will embrace the bypass trust concept. For these clients, all of the issues of gifting or discounting that can be largely dismissed in addressing the federal exclusion and portability come back into focus and need to be addressed if the state estate tax becomes a matter of concern. Lifetime gifting and creation of an irrevocable life insurance trust in decoupled states are favored planning techniques. The suggestion would be to pay attention to basis where possible to avoid giving donees the lowest basis assets that will result in future capital gains tax.

Some states permit a state-only QTIP election to be made to take advantage of the marital deduction for state estate tax purposes, even if no such election has been made for federal purposes. Others prohibit such an independent election. Still others require the federal choices to be followed, but if no federal return is filed, a state QTIP election is allowed. Where permitted, consider use of the state-only QTIP to address the decedent's excess assets over the state excluded amount—especially if an outright transfer to the surviving spouse is not favored. As indicated earlier, the IRS eased some of these concerns when it issued Rev. Proc. 2016-49, IRB 2016-42 (September 27, 2016). Here, the IRS declared that it would allow QTIP elections to be deemed valid even if the election was not necessary to eliminate estate tax liability, setting aside Rev. Proc. 2001-38, which had suggested unnecessary QTIP elections could be held invalid.

XI. Summary: Key Estate Planning Techniques in the Current Environment for Estates of Moderate Wealth

A. Powers of Appointment

Where trusts are used, consider giving the beneficiary a lifetime or testamentary general power of appointment to achieve a basis step-up at the beneficiary's death. Such a power allows the holder to appoint property to oneself, one's estates, one's creditors or the creditors of one's estate. Give the trustee or a trust protector the right to convey a general power of appointment to a trust beneficiary in an appropriate case. If the beneficiary is not likely to have a federal taxable estate, granting that person a general power exercisable at death will cause an estate inclusion, with no federal transfer tax consequence, but will result in a fair market value at death basis to the recipients of the property. Will the grant of a general power suggest too much "control" over the property in the hands of the beneficiary to whom it is given? If that is a concern, suggest that the power of appointment be limited to creditors – after ascertaining, of course, that the beneficiary is not subject to known creditor claims. Consider this planning in many contexts, including a lifetime bypass trust, a SLAT, or any other trust arrangement where a fair market value basis at death can be obtained without causing a taxable inclusion in a decedent's estate.

B. The Delaware Tax Trap

As another alternative, consider use of the more complex and sophisticated approach of using the "Delaware tax trap." Code Sections 2041(a)(3) and 2514(d). This involves providing in a trust that the beneficiary is given a limited power of appointment that includes the power for the beneficiary to grant a presently exercisable power of appointment to another person (even a limited power to appoint property in further trust) that can further postpone the vesting of the appointed property. Where this power is exercised by the trust beneficiary, the appointed property will be included in the beneficiary's gross estate—exactly the result desired when the estate will not be subjected to the federal estate tax but planning seeks a stepped-up basis for the trust assets. This result is easily avoided when the estate is too large by having the beneficiary take no action to spring the Delaware tax trap. The beneficiary controls this decision. If this technique is to be used, the beneficiary should seek sophisticated tax advice before proceeding.

C. Portability – GST Planning and the Reverse QTIP Election

For spouses, be sure to address the portability election. Do not fail to file Form 706 that results in making the necessary election. Take advantage of the extended time to file the portability election (two years from the date of the decedent's death) as outlined in Rev. Proc. 2017-34, discussed above.

Where maximizing gifts to grandchildren is desired, remember that the GST exclusion is not portable. Persons of moderate wealth can certainly take the first steps in creating a family dynasty trust which can benefit multiple generations, even if it is modestly funded in the first instance. Such a trust is best created in a state that has repealed or significantly extended the rule against perpetuities (to avoid having a forced termination of the trust as a matter of state law). A dynasty trust can offer long-term asset protection against creditors, whether they be financial, judgment or matrimonial creditors.

Have the first decedent spouse be the transferor to the grandchildren. This can be done either directly, or by creating a QTIP trust for the benefit of the surviving spouse and making the reverse QTIP election on the Form 706 filed for the first deceased spouse (complete Schedule R of Form 706 to make this election). That will make the first decedent spouse the transferor to the grandchildren and the surviving spouse will enjoy the lifetime benefits of the QTIP trust and will still have his or her full GST transfer opportunity available. Code Section 2652(a)(3)(b). A further advantage of this reverse QTIP trust planning is that the assets will receive a potentially stepped-up basis at the deaths of each spouse. If it is desired to assure that the surviving spouse will also be a transferor to grandchildren, consider creating a lifetime QTIP for the benefit of the surviving spouse with remainder to grandchildren. Code Section 2523(f). Such a trust will be included in the estate of the beneficiary spouse, who will be the transferor of the property for GST purposes, and the trust assets will obtain a potentially stepped-up basis at the death of the spouse for whose benefit the lifetime QTIP was created.

D. Flexible Planning – Disclaimers and Clayton QTIPs

Consider flexible planning that gives the surviving spouse the option of what planning to select at the first death. This is a useful suggestion for both the federal estate tax standing alone and for spouses who may live in decoupled states with their own state estate tax. Use an outright transfer to the surviving spouse with a disclaimer provision (by the surviving spouse) leading to a bypass trust where the spouse is a primary (or sole) lifetime beneficiary. This may seem to be an apparently simple choice; however, concern is often expressed as to whether the surviving spouse will actually proceed with a disclaimer. A qualified disclaimer must be made within nine months of the decedent's date of death. No extension of time to make a qualified disclaimer is available. Where a disclaimer plan is used and the surviving spouse is the beneficiary of the bypass trust to be funded by the disclaimer, the spouse may not be given a limited power of appointment over any trust which can be affected by the spouse's disclaimer—unless such a power is limited by an ascertainable standard. Reg. 25.2518-2(e)(2).

Alternatively, leave assets in a manner such that the executor of the estate of the decedent can elect QTIP treatment to the extent desired, with the balance of property possibly passing to a bypass trust or to some other beneficiaries—a so-called partial QTIP or Clayton QTIP provision. *Clayton v. Commissioner,* 976 F. 2d 1486 (5th Cir. 1992); Reg. 20.2056(b)-7(d)(3) and 7(h), Example 6.

This option takes the planning choice away from the surviving spouse and puts it in the hands of the deceased spouse's executor, who may be more objective, especially if there are blended family considerations that could cause a conflict for the surviving spouse. The regulations permit partial QTIP elections. Reg. 20.2056(b)-7(b)(2)(i).

Such a provision could also be helpful in a decoupled state estate tax situation. If an automatic extension of time to file Form 706 is obtained, (File Form 4768) the executor has 15 months from the decedent's date of death to decide to make the QTIP decision.

If desired, trusts created in this manner could give the surviving spouse a limited power of appointment. Code Section 2056(b)(7)(B)(ii)(II).

The choices to be made in a flexible plan that would involve the funding of a bypass trust could include allowing discretionary trust beneficiaries other than the spouse so that the possibility of distributing income to persons in low tax brackets will be available. The trust could also encourage the trustee to distribute appreciated assets to the surviving spouse so that they will enjoy a stepped-up basis upon the surviving spouse's death.

Where trusts are used, bear in mind the highly-compressed income tax rates imposed on trusts. Wherever possible and appropriate, allow discretion in distributing income and principal to the trust beneficiaries.

If a bypass trust is utilized, bear in mind that the trust assets may be highly appreciated at the death of the surviving spouse with no basis step-up to the trust beneficiaries at the second death. Pay careful attention to the assets used to fund such a trust. For the family with moderate wealth, appreciation of assets should be favored in places other than the bypass trust.

The moderate wealth client whose assets may be approaching the threshold where the federal estate tax could apply must continue to pay attention to asset values in relation to the law. The client could utilize a program of annual gifting to stay below the threshold if that will be sufficient, or consider more involved sophisticated planning techniques (such as GRATs, for example) to restrict appreciation from overtaking the federal estate tax threshold.

For persons living in decoupled states, be sure to address the issue of how the state exclusion will be addressed, if at all. If there is state death tax paid at the death of either spouse, be sure it was an anticipated consequence of the estate plan selected, and that this consequence was communicated to interested family members before anyone has died. Be warned of surprised and angry heirs who thought they were told there would be no death tax when their loved one died. Their surprised reaction may accurately describe the federal estate tax, but not necessarily the state death tax.

XII. Summary: Key Planning Opportunities in the Special Times of 2020

As stated in the Overview above, 2020 is a special time presenting special planning opportunities for clients of moderate wealth as well as significant wealth. Among the planning techniques to be considered in 2020 are:

A. Gifting. Values are down almost everywhere. The transfer tax exclusion is $11.58 million per person. Will the outcome of the 2020 election result in a much lower exclusion as early as 2021? Congress has said that if the current exclusion is used, and the exclusion is reduced in the future, there will not be "claw back" of the exclusion already used. Gifting to children and grandchildren (the GST exclusion is also $11.58 million per transferor) should be considered before values rebound and/or the exclusion is reduced. Transfers of business interests, real estate as well as stock portfolios should be considered.

B. Loans to Family Members. The IRS monthly published interest rates are barely above, and in some cases below, 1%. A loan to family members must bear interest at the applicable federal rate to avoid characterization as a gift. A loan to children evidenced by a note of say 10 years with an interest rate of 1.5% will not be viewed as a gift. If markets improve over time, it is likely that the children will be able to earn enough to pay the interest without difficulty.

C. Sophisticated Tax Planning Techniques. A number of sophisticated tax and estate planning techniques routinely considered by wealthy taxpayers are in an extremely favorable place now. These techniques are largely dependent on favorable (low) interest rates and low asset valuations to work to their best advantage. If moderately wealthy clients have any concern about political risk, using these techniques at this time provides an opportunity to protect their wealth and their family's future inheritance from what are likely to be higher taxes and reduced exclusions at some point in the future.

The techniques that work best for healthy clients when interest rates and valuations are low include the Grantor Retained Annuity Trust (GRAT) and the Intentionally Defective Grantor Trust (IDGT). The combination of low interest rates and low values allows more of the grantor's property to be used to fund these arrangements while keeping transfer tax costs exceptionally low for the benefit of the transactions undertaken. These techniques are very likely to be eliminated if there is major political change.

For clients whose health is not strong, but who are expected to live for at least several years, the Self-Cancelling Installment Note and the Private Annuity offer tax and estate planning opportunities that are also favored by low interest rates and low values. Like the GRAT and the IDGT, these techniques are not likely to survive major political change.

For clients that are charitable inclined, low interest rates favor the Charitable Lead Annuity (or Unitrust) – the CLAT or the CLUT that provide an upfront annuity for charity for a selected term of years, with the remainder of the trust property passing to family members. A low interest rate environment places a high value on the annuity interest (the deductible charitable interest) and a low value (or no value depending on how the trust is structured) on the remainder interest passing to the family members.

D. Roth IRA Conversions

As discussed above in Section VII, the bad news of reduced stock market holdings can be turned into an opportunity to accomplish the conversion of a traditional IRA to a Roth IRA. If it is likely that future income tax rates will be higher at some point in time than present rates, and given (a) that retirement plan benefits are taxed as ordinary income, with no basis adjustment even if received from a decedent, (b) the requirements of the SECURE Act that most beneficiaries (including those of Roth IRAs) must withdraw their retirement funds within ten years of the year of death of the plan participant, and (c) that otherwise required minimum distributions from retirement plans have been waived for 2020, it seems that 2020 is an ideal time – perhaps the last best time – to accomplish a favorable Roth IRA conversion.

All of the planning techniques suggested above are alive and well and still available in 2020. They may be allowed to continue beyond 2020 – or may disappear soon after the close of the year. Our clients deserve to be made aware of the opportunities available and how we can assist them in making them work. We need to be the thought leaders to at least start the discussions with clients to give them the chance to take advantage of what the law currently permits and favors.

Steve Leimberg's Estate Planning
Email Newsletter Archive Message #2854

Date:18-Jan-21

Subject: Bob Keebler, Jonathan Blattmachr & Martin Shenkman - After the Georgia Runoff, What Tax Planning Should You Do NOW!

"With the results of the Georgia runoff election, the Democrats control the House, the Senate and the White House. So, the potential for significant tax legislation increasing taxation of the wealthy along the lines of prior Democratic proposals might be likely to happen. What might those changes be? When might they be effective? What planning might you want to do now? Despite the uncertainty practitioners should act now to advise and guide clients. This newsletter will discuss many considerations concerning the advice practitioners might consider."

Robert S. Keebler, CPA, **Jonathan G. Blattmachr, Esq.** and **Martin M. Shenkman, Esq.** provide members with timely and important commentary that examines the estate and income tax planning considerations advisors should be discussing with clients. Members who wish to learn more about this topic should consider watching Bob, Jonathan and Marty in their 2-part LISI Webinar:

- Georgia Senate Election Results – Deep Dive PART 1 of 2 - Income Tax Planning TUE, JAN 19, 2021 1:00 PM - 02:30 PM EST
- Georgia Senate Election Results – Deep Dive PART 2 of 2 - Estate Planning to do NOW! TUE, JAN 19, 2021 3:00 PM - 05:00 PM EST

Robert S. Keebler, CPA/PFS, MST, AEP (Distinguished) is a partner with **Keebler & Associates, LLP** and is a 2007 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planners & Councils. He has been named by CPA Magazine as one of the Top 100 Most Influential Practitioners in the United States and one of the Top 40 Tax Advisors to Know During a Recession. Mr. Keebler is the past Editor-in-Chief of CCH's magazine, Journal of Retirement Planning, and a member of CCH's Financial and Estate Planning Advisory Board. His practice includes family wealth transfer and preservation planning, charitable giving, retirement distribution planning, and estate administration. Mr. Keebler frequently represents clients before the National Office of the Internal Revenue Service (IRS) in the private letter ruling process and in estate, gift and income tax examinations and appeals. In the past 20 years, he has received over 250 favorable private letter rulings including several key rulings of first impression. Mr. Keebler is nationally recognized as an expert in estate and retirement planning and works collaboratively with other experts on academic reviews and papers, and client matters. Mr. Keebler is the author of over 75 articles and columns and editor, author, or co-author of many books and treatises on wealth transfer and taxation, including the Warren, Gorham & Lamont of RIA treatise Esperti, Peterson and Keebler/Irrevocable Trusts: Analysis with Forms. Mr. Keebler is the Chair of the AICPA's Advanced Estate Planning Conference. He is a featured columnist for CCH's Taxes Magazine - Family Tax Planning Forum, Bob is also a contributing author to the American Bar Association's The ABA Practical Guide to Estate Planning.

Jonathan G. Blattmachr is **Director of Estate Planning for Peak Trust Company** (formerly Alaska Trust Company), co-developer of **Wealth Transfer Planning**, a computer system for lawyers, published by **Interactive Legal Systems** and its Editor-in-Chief, director of **Pioneer Wealth Partners, LLC**, author or co-author of nine books and over 500 articles, and a retired member of Milbank, LLP, and of the Alaska, California, and New York Bars.

Martin M. Shenkman, CPA, MBA, PFS, AEP, JD is an attorney in private practice in Fort Lee, New Jersey and New York City who concentrates on estate and closely held business planning, tax planning, and estate administration. He is the author of 42 books and more than 1,200 articles. He is a member of the NAEPC Board of Directors (Emeritus), on the Board of the American Brain Foundation, the American Cancer Society's National Professional Advisor Network and Weill Cornell Medicine Professional Advisory Council.

Here is their commentary:

EXECUTIVE SUMMARY:

With the results of the Georgia runoff election, the Democrats control the House, the Senate and the White House. So, the potential for significant tax legislation increasing taxation of the wealthy along the lines of prior

Democratic proposals might be likely to happen. What might those changes be? When might they be effective? What planning might you want to do now? Despite the uncertainty practitioners should act now to advise and guide clients. This newsletter will discuss many considerations concerning the advice practitioners might consider.

COMMENT:

<u>How Do the Dems "Control" the Senate</u>?

The Senate has a 50/50 Dem/Republican split, so that does not sound like control. But Vice President Kamala Harris will cast the tie-breaking vote and that equates to control, except to the extent a filibuster arises which takes 60 votes to end it. Might that suffice to push through major tax legislation? Certainly, and it would not be the first time. In 2001 Vice President Dick Cheney cast the deciding vote in the Senate in the adoption of the Tax Reform Act of 2001 which ushered in significant tax changes, and we may face similar situation this year. Note that, among other Senate legislation, a filibuster cannot be engaged with respect to a budget reconciliation act, which is likely how tax changes under the Biden administration will occur, as it did under the Trump and other administrations.

<u>Be Wary of Retroactive Estate Tax Changes</u>

Retroactive changes to the tax law be viewed by some as not fair. How can Congress retroactively change the tax rules? Well, it may feel unfair, but it is legal to do and Congress might choose to do it! One of the tax changes that some commentators suspect might be retroactive is the reduction in the transfer tax exemption (the amount you can gift or bequest to an individual   without incurring a gift, estate or generation-skipping transfer tax). Specific suggestions on how to guide clients to possibly protect themselves against such a retroactive reduction in exemption are provided below. While nothing can be known with certainty, there have been several cases holding that retroactive tax changes are legal.

For a retroactive change in the law to be respected, it must be rationally related to a legitimate legislative purpose. Raising revenue in the midst of a pandemic with historic bailout packages would seem easily sufficient to meet this requirement. Cf. Pension Benefit Guaranty Corporation v. R. A. Gray & Co., 467 U. S. 717 (1984); United States v. Carlton, 512 U.S. 26 (1994).

So, when planning what type of wealth transfers you might recommend clients complete this year in hopes of preceding the effective date of future legislation, caution clients to consider the risk of some changes being enacted retroactively. That is important as it can and, perhaps, should affect how clients structure wealth transfers in 2021. This planning will be described below.

Be Wary of Retroactive Income Tax Changes

Retroactive tax changes could also include income tax changes. Retroactive income tax changes might be viewed as less likely than retroactive estate tax changes. That could be because of the complexity a retroactive income tax change might create (but do not read that as implying it cannot happen). Income taxes are paid in quarterly based on estimates. And some changes, like an increase in tax rates on long-term capital gain can simply be made to apply to sales after a certain date. A retroactive change could adversely affect the potential for interest and penalties on amounts clients paid in through withholding taxes and estimated taxes all based on prior law. In contrast, estate taxes are due nine months following death so that a retroactive change might be less problematic for Congress to enact.

Example: An individual owns commercial real estate and is considering a Code Section 1031 "like-kind" exchange. This is where a taxpayer swaps or exchanges an investment real property for another real estate investment property and there is no current gain recognition for income tax purposes. In other words, under current law, one can exchange real estate instead of selling it and avoid any current income tax. A repeal of section 1031 may be on the tax agenda. It has been talked about before. So, if someone plans a Section 1031 like-kind exchange care should be taken as Congress might enact a repeal (or restriction) and might make the change retroactive to January 1, 2021. So, clients might wish to discuss with their real estate attorneys whether it is feasible to incorporate into the contract sale/exchange documents that the transaction will be automatically void if the law changes retroactively before the transaction is consummated.

Also consider the impact of a repeal or significant restriction on Code Section 1031 on transfers to grantor trusts. Clients may have used Section 1031 to exchange real estate assets held in a grantor trust that did not benefit from a basis step up on death. That step-up in basis safety valve may be eliminated. And regardless of whether any tax changes are retroactive, this type of change could have an adverse impact on those who sold large real estate interests to grantor trusts counting on the use of Section 1031 as an exit strategy for properties that would not obtain a basis step up.

Some of the Possible Income Tax Changes

There could be a myriad of income tax law changes that a new Biden administration may seek to enact. The discussion below summarizes a few of the likely changes a Biden Administration might seek to have enacted. Some of these changes could have a profound impact on estate, charitable and other tax planning as well. Indications are that the tax increases will generally if not exclusively be targeted at higher income and higher net worth taxpayers. Several of the changes might be targeted at those earning $400,000 plus, some at those earning $1 million plus.

Capital Gains Tax

Capital gains taxes could be raised substantially. They have discussed essentially doubling the tax rate on capital gains by taxing capital gains as ordinary income. And those gains could also be subject to the 3.8% net investment income tax. Adding in state income tax if the particular client resides in a high tax state means the effective tax rate on capital gains over $1 million could exceed 50%. If this change is enacted, practitioners should expect a tremendous amount of sales of assets before the effective date of that change.

Some commentators have speculated that a capital gains tax rate change could also be made retroactive to January 1, 2021, but others believe that is unlikely. Some have suggested that such a change might be made effective January 1, 2022. Or there could be an effective date based on the date of enactment of the tax legislation. This will affect planning dramatically. It might prove to be advantageous to sell appreciated assets now and lock in the current capital gains tax rate if the changes aren’t retroactive. An installment sale might be appropriate to consider.

If you sell assets on the installment basis you would pay tax when the proceeds are received (plus a potential interest charge). You might instead prefer to elect out of installment sale treatment for income tax purposes so that you have a gain recognized at the current and, perhaps, lower capital gains rate.

CRTs and Capital Gain Planning

Strategies to try to ameliorate the impact of possible law changes may include gain/loss management, installment sales, or charitable remainder trusts (“CRTs”). It should be noted that a transfer of highly appreciated stock to a CRT now might prove disadvantageous as capital gains after the effective date of a law change may then be taxed at a new higher rate. It might be more advantageous for the client to simply sell an asset at the current lower tax rates. The suggestion for the possible use of CRTs after a change in the capital gains rules is to use CRTs in that context to smooth income between taxable years to keep income overall under the $1 million level where only the 20% capital gains tax rate (rather than the 39.6% ordinary income rate) may apply.

If capital gains rates are increased on gains over $1 million (or when income for the year exceeds $1 million), then consideration may be given to the use of CRTs to smooth out or reduce income. CRTs are exempt from income tax. So, if you gift appreciated stock into the CRT and the CRT sells it, no gain is recognized at that time. If you use a NIMCRUT (a net income with make-up charitable remainder trust), you can postpone gain for up to 20 years. Perhaps, rates may be lowered again in the future.

An individual can donate appreciated stock to a CRT. The CRT can sell the stock without realizing gain since CRTs are tax exempt. As the grantor (or other beneficiaries) receive periodic payments from the CRT (e.g., a unitrust payment), the payments will flow out tax income from the CRT to the beneficiary. In other words, the cash flow distributed by the CRT as part of the periodic payments will be characterized and taxed based on the income earned by the CRT. So, if the CRT sold appreciated stock and realized a capital gain, that gain would flow out to the beneficiaries over many future years as capital gain. If the capital gains tax rate is increased in those future years, using a CRT today might effectively defer taxation of capital gains income to later years when the tax rate is higher.

A traditional estate planning/CRT planning technique was the use of a so-called wealth replacement trust. The CRT would be paired with an irrevocable life insurance trust (“ILIT”) that would be used to approximately replace for heirs the estimated wealth to be transferred to charity at the end of the CRT term. Practitioners should bear in mind that another proposed change, capping annual exclusion gifts at $20,000/donor, could impede this type of planning as gift tax free contributions to pay the premiums may be inhibited.

Should Assets be Sold Before Capital Gains Rates Increase?

It may prove advantageous to sell some of those appreciated assets in 2021 if the law change increasing capital gains to ordinary income tax rates only takes effect in 2022 and not this year. When evaluating the guesstimated cost/benefits of selling now versus waiting, also consider possible state income tax costs and planning. It may be advantageous to shift assets into an incomplete gift non-grantor ("ING") trust in a trust friendly (i.e., no state income tax) jurisdiction so that state income tax can be avoided. A taxpayer might, for example, provide in such a non-grantor trust that distributions can only be made to a spouse with the consent of an adverse party to prevent the trust from being a grantor trust under Code Sections 676 and 677 because distributions can be made to the grantor's spouse. Grantor trust status, which of course, will attribute all trust income directly to the trust's grantor, will not apply under those sections if the distributions to the spouse may be made only with the consent of an adverse party. That mechanism may permit a spouse to benefit from trust assets, not undermine characterization as a non-grantor trust, and still permit avoiding state income tax on a large sale to avoid an increase in the capital gains tax. Note that in Rev Proc. 2021-3 the IRS stated that it will no longer rule on ING trusts so caution is in order.

A transfer to a non-grantor trust can be structured as a completed gift or incomplete gift. One may transfer assets to an incomplete gift trust without resulting in gift tax even if the transferor's entire gift tax exemption has been used and still create a structure to avoid the state income tax on the sale. If the taxpayer has gift tax exemption remaining, then the taxpayer may want to try to use exemption and structure the non-grantor trust as a completed gift to the extent of the remaining exemption. Several options may be available to review with a client, but the uncertainty of how the tax law will develop, risk of retroactive change, etc. probably should be kept in mind. Note also that New York has anti-ING legislation providing that if the transfer to the trust is incomplete, the trust will be treated as a grantor trust for New York income tax purposes even if the trust is not a grantor trust for Federal tax purposes. And similar legislation has been proposed in California.

Charitable Giving

Charitable and other deductions might continue to be allowed, without dollar limitations like those that now apply to state and local tax deductions under a Biden tax proposal, but the benefit may be less than initially perceived because of some of the limitations discussed later. Under current law you may receive a 20-100% of adjusted gross income (specially determined) charitable deduction, but some Democrat proposals provide that all itemized deductions be limited to a 28% maximum benefit. In other words, even if the taxpayer is in a 39.6% income tax bracket, the benefit of the contribution deduction might be capped at 28%. The Pease rule, discussed below, might also be readopted.

Social Security Base May Increase: If someone earns compensation income, a 12.4% Social Security tax is imposed on the first $142,800 of that income under current law. But Biden proposals might leave a gap from that amount up to $400,000 on which no Social Security tax is paid. But once income exceeds $400,000, the 12.4% Social Security tax would again apply to the excess compensation income. So, under one Democrat proposal, if enacted, if a taxpayer earned $1 million there would be approximately another $74,000 of just Social Security taxes on those earnings (combined with the 39.6% income tax and state income tax). One potential approach to reduce this tax burden has been to organize as an S corporation and take some portion of earnings as salary subject to Social Security, and the remaining portion as S corporation dividends which is not subject to the tax. But the IRS has been somewhat successful in attacking many of these plans under a "reasonable compensation" approach, thereby converting S corporation income into compensation that is subject to the 12.4% tax. The taxpayer will have to take out a reasonable salary comparable to what a similar executive might earn. Congress might close this planning technique down by saying if you are a personal service provider, e.g., a doctor, lawyer, architect, etc. you may not be able to avoid the tax by using an
S corporation.

Marginal Tax Rates May Increase: How might future rates look? Today's maximum income tax rate is 37%. President elect Biden's proposal might increase this to a 39.6% marginal rate. But also consider that certain investment income might still be subject to the net investment income tax ("NIIT") of 3.8% making the effective rate higher still. Income tax rates have not generally been made effective retroactively as it makes tremendous complications with withholding and estimated taxes. So, toward the end of 2021 a taxpayer may well do Roth conversions, accelerating gains, etc. to avoid the tax increase to 39.6% if that rate is to become effective next year.

Pension and Retirement Plans: Consider what might happen with pensions. They might restrict the benefit of an income tax deduction for contributions to a qualified plan or traditional (non-Roth) IRA to 28% even if the taxpayer is in a higher income tax bracket. If a taxpayer contributes money into a pension plan or IRA and can only get 28% benefit but when he or she retires and withdraws from the plan or IRA, those funds are taxed at 39.6%, it may not make any sense to make the contribution. Of course, while in the plan or IRA, income will grow tax deferred. One problem is that it is difficult to project what marginal tax rates will exist in the future, and it is even more difficult to predict what marginal rates will apply to a particular client in the future. Also note that qualified plan assets and IRAs (depending on state law) may provide asset protection from most creditor claims. Thus, some taxpayers who are particularly concerned about liability issues might opt to maximize pension contributions even if not optimal from an income tax perspective.

Pease Limitation: May further restrict itemized deductions. This provision, contained in Code Section 68, limits deductions by reducing most itemized deduction by 3% of adjusted gross income (but by not more than 80% of them) once income (which is inflated adjusted) exceeds a certain threshold. The combination of this limitation and the 28% proposed benefit cap for itemized deductions will make itemized deductions much less valuable for high income taxpayers.

Section 199A: This Code section that permits a deduction to reduce the taxation of many businesses might be restricted. One possibility is that when a client reaches $400,000 of income, the deduction may be reduced.

Corporate Tax Rates: These rates may increase from 21% to 28%. That might change the calculus of when to create a C corporation versus using a pass-through entity, what format to hold assets in, etc.

Roth Conversions: If income tax rates increase, it may be advantageous to convert a regular IRA to a Roth IRA and pay the tax now at lower rates. Consider charitable contributions, loss carryforwards and other ways to offset some of the gain if a conversion from an IRA to a Roth IRA is considered. Many people do their own tax returns and get their advice on planning from IRA custodians that provide packaged investments. These taxpayers may not be able to receive the sophisticated tax advice that is customized to their unique situation. Also, consider the impact of state income tax on a Roth conversion when advising these clients. There is no NIIT (net investment income tax) under Code Sec. 1411 on a conversion. It generally will be preferable to pay the income tax on the conversion from funds outside the IRA. Roth IRAs provide true tax free (as opposed to only tax deferred) compounding which can be very valuable. Regardless of whether a conversation to a Roth IRA conversion occurs, it is appropriate to review beneficiary designations in light of the Secure Act that became effective in 2020 which limits the time, in many situations, during which distributions from a plan or IRA may be taken without penalty. Most beneficiaries will no longer qualify for the so-called “stretch” payout (that is, taking distributions from the plan or IRA over their life expectancies) so an evaluation of post-death payout options should be made which, in turn, may necessitate an update of trusts and beneficiary designations that will receive distributions.

Other Possible Income Tax Changes

There are many other changes that have been noted in various Democrat proposals, and no doubt the process that tax legislation often entails may well result in a unique mix of many impacted income tax rules.

Step-Up In Income Tax Basis on Death

Most assets included in a client’s gross estate will, under Code Section 1014, have their income tax bases adjusted to equal their fair market value at the date of death (or, if elected, on the alternate valuation date, normally, 9 months later). So, if stock was purchased for $1,000 that is worth $100,000 at death, the step up would eliminate the entire capital gain on the $99,000 inherent profit.

President Elect Biden has indicated he would like to see an elimination of the step up in income tax basis on death. That might convert the tax system to what is referred to as a “carry over basis” system. So, the $1,000 paid for the $100,000 of stock would carry over as the basis to the owner’s estate and heirs. Potentially more impactful would be the enactment of a system analogous to the Canadian estate taxation regime where there is a capital gain tax assessed on death. There might also be a combination of approaches, perhaps giving taxpayers an option to choose to remain subject to an estate tax and thereby also obtaining a step up in income tax basis, or to instead face the loss of step up and avoid a capital gains tax on death as was available for those who died in 2010. A recognition of gain at death would a be a very far-reaching change that could have a significant impact on planning.

Consider that under current law many who are elderly or have a terminal condition are advised to intentionally hold highly appreciated assets until death to obtain a basis step up. In some instances, taxpayers create lines of credit to borrow against appreciated securities to avoid selling them. If a capital gains cost will be triggered on death that may eliminate the incentive to hold assets changing many estate planning, investment and other decisions.

Reduction in Gift, Estate and GST Exemption Amount

The exemption is an amount that one may transfer without incurring a gift, estate or generation-skipping transfer ("GST") tax cost. The current exemption for all three of these tax systems is the same at $11.7 million in 2021. There are Democrat proposals to reduce the estate and GST tax exemption from $11.7 million to $3.5 million or $5 million (perhaps, inflation adjusted, perhaps not) and the gift tax exemption to only $1 million. It is not clear what might occur, but a reduction seems likely according to some commentators. It might even be reduced lower. Will this be made retroactive? No one knows. While it certainly seems inherently unfair to make such a change retroactive (a client made a gift thinking it was tax free then a retroactive change made it taxable), it just might occur. Of all changes to the estate tax rules that might be retroactive, a reduction in the exemption is suggested by some commentators to be one of the more likely. Such a change would profoundly change estate planning and subject millions of taxpayers, now unaffected by estate tax, to the tax. The critical and urgent planning message of this possibility is that those taxpayers who did not consummate estate tax transfer planning before the end of 2020, or who did not do as much as perhaps they should have, should consider acting soon. There is no assurance that planning will succeed given the uncertainty about the effective date of any such changes. It would also seem that the longer one waits in 2021 to plan, the greater the risk that a change in the law may become effective before the taxpayer completes planning.

How a Client May Use Exemption Now While You Can (Maybe!)

What is the efficient way to use exemption now? Practitioners are well aware that gifts to irrevocable trusts are the preferred way to transfer assets for several reasons. Clients are often less aware of the benefits of trusts and may need to be educated that a robust trust can provide considerable flexibility. For example, the trust may include a disclaimer provision that could be used to unravel the gift if it is determined to be undesirable or there is a retroactive change in the law rendering a non-taxable gift taxable. See Code Sec. 2518. The trust might also provide flexibility to shift income among a class of beneficiaries which could be useful depending on the other income tax changes that are enacted. Practitioners may guide clients to consider how much access the client may directly or indirectly have to assets transferred to a trust. On one hand, many taxpayers will want sufficient access so that they do not face financial hardship. But any means of access, on the other hand, needs to be balanced against the increased risk of an IRS challenge to the arrangement, or a creditor being able to reach the transferred assets. Means to access assets in an irrevocable trust might include making a spouse a beneficiary, creating a self-settled domestic asset protection trust ("DAPT") that the property owner is a beneficiary of, creating a so-called "hybrid-DAPT" which is a trust for heirs (e.g., for spouse and descendants). With a hybrid DAPT, the property owner is are not a current beneficiary but someone acting in a non-fiduciary capacity can add him or her as a beneficiary).

What do taxpayers do who cannot easily transfer "assets" to use the exemption now? It may be possible to borrow against the assets and gift the cash borrowed to a trust. That may shift value out of the property owner's estate using exemption and the asset that could not be transferred (e.g., because of legal restrictions) remains in his or her estate but is reduced by the amount of the borrowing, thus lowering the transferor's taxable estate. This may also allow the retention of low basis assets to remain in the estate and receive a step-up in basis at death but allow his or her current net worth to be used to take advantage of current gift and GST exemptions.

Grantor Trusts

Grantor trusts are the foundation for many estate planning techniques. Grantor trusts are trusts for which the income is attributable under Code Sec. 671 to the settlor so that the settlor, and not the trust, pays income tax on trust income without being deemed to have made a gift by doing so. See Revenue Rulings 85-13 and 2004-64. Moreover, the grantor can sell assets to a trust that is a grantor trust and not recognize gain for income tax purposes on that sale. There are proposals to include assets held in grantor trusts in the settlor's estate on death, or to subject assets in such a trust to immediate gift tax if grantor trust status is terminated during the grantor's lifetime.

Planning to Address Possible Retroactive Change in Exemption: What if a taxpayer makes a gift and Congress retroactively changes the exemption? The exemption today is $11.7 million. Assume a client gifts that amount, to safeguard and preserve their entire exemption, to a trust and. in June, Congress passes new tax legislation and makes the gift exemption a mere $1 million retroactive to January 1, 2021. Did the taxpayer just make a $10.7 million taxable gift? While unfair, it appears that could be a result. What can practitioners suggest clients do to avoid or mitigate this possible risk of an unintended gift tax consequence? There are a number of options that practitioners might consider for any 2021 gifts given this uncertainty. The client could make a gift to a marital-type trust (QTIP-like trust) if the client is married to a US citizen. The client could then evaluate making a QTIP election on their gift tax return reporting that gift. Making the QTIP election could avoid a taxable gift. A taxpayer could, for example, make a marital QTIP election for $10.7 million of the gift leaving the $1 million taxable gift to be offset by the new reduced exemption. If the estate is large enough for each spouse to do this type of $11.7 million transfer, there will be another issue to consider. If both spouses do this plan it could be problematic under the reciprocal trust doctrine. That doctrine could “uncross” the trusts if they are too similar and unravel the plan. So, this approach might be safer if used by only one spouse to transfer $11.7 million.

Make a Formula Gift: Another approach to consider is to make a gift to a trust using a formula which will limit the taxable gift to the amount of the exemption that ultimately applies to it. The transfer documentation transferring assts to the trust could gift that fractional share of the asset the numerator of which is the available gift tax exemption, and the denominator of which is the full value of the gift as finally determined for gift tax purposes. The taxpayer, for example, could contribute assets into a limited liability company (“LLC”) and make a transfer of a fractional interest in the LLC to the trust. The numerator should consider the possibility of retroactive changes in exemption amount. So, it might be worded to be the gift tax exemption, reflecting a retroactive tax law change, if any. This concept is based, in part, on standard dispositions by married decedents who bequeath their estates, based upon formulas using the amount of available estate tax exemptions, into two parts, one equal to the amount of the exemption and the other qualifying for the estate tax marital deduction. The concept also seems supported by the Wandry case which respected a formula gift. Wandry v. Commissioner, T.C. Memo 2012-88. Also, it seems very important to use appropriate language in the formula stating that the value transferred is the value “as finally determined for federal estate and gift tax purposes.” In the Nelson case the taxpayer did not use the appropriate terminology and lost. Nelson v. Commissioner, T.C. Memo 2020-81. Also, consideration likely should be given to how to tailor this type of formula clause. What if the GST tax exemption is different than the gift tax exemption? Do you need to have different formula clauses for each tax? If the taxpayer is gifting a group of assets, one might also consider ordering. That is, in what order should exemption be allocated to assets? A prioritization of allocations might be advisable to include in such instances.

Disclaimer Strategy: There is yet another approach that might be considered in planning 2021 gifts to address the risk of a retroactive tax change. The taxpayer makes transfers of assets by gift so a so-called "family trust" and provide in that trust instrument that the client's spouse (for example) shall be treated as the principal beneficiary of the trust. And the trust would further provide that, that to the extent the spouse disclaims (renounces) all his or her interest in the trust, the disclaimed interest does not "move down" to other beneficiaries as if the spouse died (the typical result of a disclaimer), but rather the asset reverts back to the donor. This might avoid an inadvertent gift tax if there is a retroactive change in exemption amounts. The spouse might disclaim pursuant to Code Sec. 2518 to the extent the transfer exceeds the exemption amount if the exemption amount is changed. That disclaimer must be completed within nine months of the gift. In order to have the disclaimer be qualified under Code Sec. 2518, he or she cannot accept any benefit from the trust before exercising the disclaimer.

GRAT Strategy: It may be possible to consider utilizing GRATs to address this issue. Suppose that a client sets up multiple GRATs aggregating $11.7 million of gifts. If it is later learned that the gift tax exemption has been reduced, the client could selectively determine to intentionally fail meeting the regulatory requirements for GRAT treatment on those GRATs necessary to use the adjusted exemption amount. For GRATs above that amount GRAT rules could be adhered to thereby reducing the value of any current gift to the modest or zero amount under the initial GRAT calculation. It is not clear that this approach would be successful. The problem could be analogous the lines of the arguments with respect to intentionally violating QPRT requirements to cause estate inclusion for a basis step up. Caution is in order.

Rates: Consider that under the Bernie Sanders tax proposal estate tax rates were to become graduated up to 77% (for transfers above $1B). So, higher estate, gift and GST rates may be a possibility.

Discounts: When an asset is valued for gift and estate tax purposes, the value may be reduced, among other cases, if the transfer is of a non-controlling interest in an entity. For example, if a taxpayer owns 25% of a family business worth $10 million, his or her 25% interest might be valued at less than the pro-rata $2.5 million because the taxpayer has no ability to control the enterprise, distributions, liquidation, etc. These so-called valuation discounts may be eliminated in Democratic tax legislation or possibly by regulatory changes. So, it may be advisable to engage in transactions now to lock in discounts.

Example: If a taxpayer's spouse died and left the survivor valuable assets in a marital deduction trust (or outright) those assets may be taxed on the survivor's death. It might be advantageous to consummate transfers now, while discounts, larger exemptions and lower rates remain possible. One might consummate an installment sale from a marital trust (a "QTIP" trust described in Code Sec. 2523(f)) to lock in the low AFR interest rate and discounts which may be eliminated.

What should be considered on a sale from a QTIP trust to a non-grantor trust? What about Code Section 2519? This Code Section says if the surviving spouse relinquishes any of his or her income interests in a QTIP trust, he or she will be deemed to have made a gift of the entire value of his or her income interest in the trust. And, on account of Section 2703, it likely will cause the spouse to have made a gift of the entire value of the trust. Estate of Kite v. Comm'r, 2013 T.C. Memo. 43, 105 T.C.M. 1277, 2013 Tax Ct. Memo LEXIS 43. Instead, perhaps, the trustee should invade the trust, transfer the assets to the surviving spouse and have him or her make the sale. That might be safer. But be certain that if you make a principal distribution the trust permits that. Consider bifurcating the QTIP trust. If the QTIP trust is divided into two QTIP trusts and only the portion holding the stock to be sold consummates the sale, perhaps the second QTIP will be insulated from a Section 2519 attack. Note, however, that the Kite case involved such an invasion followed immediately by an exchange by the spouse but it involved rather extreme facts.

GRATs: Grantor retained annuity trusts ("GRATs") described in Reg. 25.2702-3 are a technique in which assets are gifted to a trust in exchange for an annuity. If the total return on the trust assets exceeds the Code Section 7520 rate used to determine the value of the annuity stream and the remainder following it, the GRAT will produce a tax-free transfer to beneficiaries. The greater the excess return, the larger the tax-free transfer will be. This technique may become extinct because new legislation may require that 25% of the value of the assets transferred to the GRAT be a taxable gift rendering the technique impractical to use in almost all cases

Generation Skipping Transfer ("GST") Tax: The Democrats have discussed assessing a GST tax on long term trusts every 50 or 90 years. This proposal is not a revenue raiser for the government, but it is primarily a social objective of minimizing the concentration of wealth.

Annual Exclusions: There is a proposal to cap these at $20,000/donor. Presently, it is $15,000 per donee.

Conclusion.

Practitioners faced an incredible amount of work in 2020 as clients endeavored to complete wealth transfers before 2021 in case the Democrats gained control over Congress and passed retroactive tax changes. That control has now occurred. So, now, in 2021, until legislation is proposed, and effective dates are known, clients who did not complete all appropriate planning in 2020 probably should continue to plan in advance of any changes. Practitioners should explore continuing to use many of the same planning techniques used in 2020 (irrevocable trusts that preserve access to assets, GRATs modified to reflect the possibility of rolling or cascading being eliminated by legislation, etc.). One unique aspect of 2021 planning that was not broadly under consideration in 2020 is incorporating into 2021 transfer mechanisms to reduce the taxable transfers if the exemption is reduced retroactively. While many practitioners may view the likelihood of a retroactive tax change as low, this article has provided an array of options that might be offered to clients so that they can make a decisions whether or not to take those precautions. Practitioners may also wish to consider advising clients of the uncertainty as to effective date and law changes and that the impact on planning cannot be known. Those issues aside, it does seem prudent for those who failed to plan in 2020 to consider planning now. Finally, this article has provided an overview of a several income tax proposals that may be incorporated into a tax bill and the impact those may have on estate and overall planning.

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

Bob Keebler
Jonathan Blattmachr
Marty Shenkman

CITE AS:

Situs Your Trust in a First-Tier Trust Jurisdiction

By Steven J. Oshins, Esq., AEP (Distinguished) and Mark Dreschler

Not all jurisdictions have favorable trust laws. In fact, most jurisdictions' trust laws are inferior in comparison to those of the first-tier trust jurisdictions.

Despite the limitations found in most trust jurisdictions laws, estate planners generally limit their planning to the client's home jurisdiction. This article will provide multiple reasons not to do so and will explain some of the opportunities that are lost by failing to consider a top trust jurisdiction.

COMMON REASONS TO SITUS A TRUST IN A TOP-TIER TRUST JURISDICTION

Following are some of the common reasons to situs an irrevocable trust in a different jurisdiction:

State Income Tax Savings: There is almost never a good reason to maintain an irrevocable trust in a jurisdiction that has a state income tax on trusts at any point in which the trust is a non-grantor trust for income tax purposes. Such trusts should almost always be moved to a state that has no fiduciary state income tax on undistributed income. This is especially important when a lot of the trust income will not be distributed to the beneficiaries either because the beneficiaries are in a high income tax bracket, where the beneficiaries should not receive large distributions and/or where the beneficiaries have creditor issues and therefore should not receive large distributions for that reason.

Creditor Protection: Many trusts are drafted to give the trustee the power to make distributions to the beneficiaries for their health, education, maintenance and support. These trusts are often called "support trusts" for creditor purposes. Depending upon state statutes and case law, support trusts are often available to certain classes of creditors, including divorcing spouses. A discretionary trust, on the other hand, gives the trustee absolute discretion over distributions and thus generally protects the assets from all classes of creditors. [The only exception to this date is the 2013 Florida case, Berlinger v. Casselberry, where the Court ruled that a discretionary trust domiciled in Florida is subject to a writ of garnishment for unpaid alimony.] However, when the trust has been drafted as a support trust, it is imperative that the trust be domiciled in a state that protects the trust assets from various exception creditors.

Decanting: Many jurisdictions have a decanting statute. A decanting statute allows the trustee to distribute the trust assets into a different trust with different provisions for one or more of the beneficiaries of the prior trust. This flexibility can become very important when there is a drafting error, a change of circumstances or an enhancement that the family would like built into the trust, such as an ability to save taxes or to enhance the creditor and divorce protection. The failure to consider using one of these jurisdictions (or at least allowing the trustee or trust protector to move the trust to a favorable decanting jurisdiction) could mean that the desired changes cannot be made.

Domestic Asset Protection Trusts: Domestic Asset Protection Trusts have become one of the most popular and widely-used asset protection techniques. Only certain jurisdictions have favorable statutes allowing the settlor to set up a Domestic Asset Protection Trust. Although many attorneys are taking advantage of this, many others are not. Some have failed to use this technique because of the uncertainty about whether it will work for a resident of a state that doesn't have a Domestic Asset Protection Trust statute. There will not be a 100% success rate, but in almost all situations, this technique will help the client negotiate a favorable settlement. To enhance the results, instead of using a regular Domestic Asset Protection Trust, the planner can create a Hybrid Domestic Asset Protection Trust which is actually third-party trust that can be turned into a Domestic Asset Protection Trust. This is the go-to technique for a client who's a resident of a jurisdiction that doesn't have a Domestic Asset Protection Trust statute.

Dynasty Trusts: Dynasty Trusts aren't just estate tax savings vehicles. They are also used to provide asset protection and divorce protection for the beneficiaries for as many generations as applicable state law allows. Just as attorneys should use lifetime trusts to protect assets from estate taxes, creditors and divorcing spouses for the first generation, the same concepts apply to more remote generations as well. There is no reason not to protect the assets for grandchildren, great-grandchildren and other beneficiaries. Thus, it is important for the estate planner to consider situsing the irrevocable trust in a state with strong Dynasty Trust statutes.

CONCLUSION

There are many reasons not to simply use the local state trust laws. Just because nearly every estate planner relies solely on the client's local state laws doesn't mean that the more advanced estate planner should follow suit. It can cost the client's family a significant amount of money in unnecessary taxes, expose assets to creditors that could easily have been avoided and cause the family to miss opportunities for enhanced flexibility.

Should you, as an estate planner, wish to set yourself apart from your competitors and offer trust enhancements that aren't available locally, consider situsing the trust in a top-tier trust jurisdiction.

Link to: https://ultimateestateplanner.com/2020/12/02/situs-your-trust-in-a-first-tier-trust-jurisdiction/

ABOUT THE AUTHORS

Steven J. Oshins, Esq., AEP (Distinguished) is a member of the Law Offices of Oshins & Associates, LLC in Las Vegas, Nevada. He was inducted into the NAEPC Estate Planning Hall of Fame® in 2011. He was named one of the 24 "Elite Estate Planning Attorneys" and the "Top Estate Planning Attorney of 2018" by The Wealth Advisor. Steve was also named one of the Top 100 Attorneys in Worth and is listed in The Best Lawyers in America® which also named him Las Vegas Trusts and Estates Lawyer of the Year in 2012, 2015 and 2018 and Tax Law Lawyer of the Year in 2016 and 2020. He can be reached at 702-341-6000, ext. 2, at soshins@oshins.com or at his firm's website, www.oshins.com.

Mark Dreschler co-founded Premier Trust in 2001. He has been the Company's president and CEO since inception. Mark has forty-five plus years in the trust industry and currently employs a staff of over fifty. Mark has been and is currently involved with the Las Vegas and greater Nevada professional and local communities. He is on the PBS Planned Giving Board and is a speaker at live seminars in northern and southern Nevada educating the public on trusts and estates.

A WHOLE NEW WORLD:
INSURANCE

By **Richard L. Harris**

How COVID-19 and Interest Rates Affect Life Insurance

Two major developments practitioners should know about

Practitioners should be aware of two major developments in 2020: (1) changes in procedures to deal with COVID-19; and (2) the effect of low interest rates on life insurance performance.

COVID-19

COVID-19 caused underwriting and technology changes as well as an increased interest in the cash value life insurance and life settlement markets.

Underwriting. The proposed insured must now answer COVID-19 questions on the application and sign both the application and a health statement on policy delivery.

The process of getting medical exams got easier for proposed insureds ages 65 and under who have recent medical records. Because of the reluctance of individuals to allow strangers into their homes to do medical exams, many companies increased the amount of insurance these proposed insureds could get without undergoing an exam.

Insurance companies have also become more restrictive in how much insurance they'll issue to older proposed insureds (that is, those who are over age 65). If an older proposed insured has a health impairment that would result in a rating below a certain class (usually class B), the company won't issue a policy or will limit the amount of insurance for that policy. For example, Prudential has reduced the amount of insurance it will issue to $10 million on a single life and $20 million on two lives.

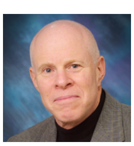
Technology. The process of completing the application got easier for everyone, as the agent and the client no longer needed to meet in person. Instead, they can now complete applications using DocuSign or a similar service. The insurance company can get medical, financial and other pertinent information by phone and deliver policies electronically. For smaller cases ($1 million or less), the underwriting process can be done electronically, and policies can be issued in about a week from start to finish, if the appropriate information is available. If you have a client who's reluctant to get insurance because of the risks of meeting in person, make sure the client knows of this change.

Cash value life insurance and life settlements. COVID-19 has adversely affected some clients' finances. People have been laid off from jobs. Clients have taken pay cuts or retired earlier than they planned. Business owners have seen their businesses go dormant or close. As a result, clients may be interested in taking advantage of existing cash value life insurance or participating in the life settlement market.

Life settlements may also help clients who are suffering financially due to COVID-19. I recently worked with a client whose mother had a substantial life insurance policy that she could no longer afford. The client also had a business that had a cash crunch. He was able to get a life settlement that both ended the drain on cash trying to keep the policy in force as well as provide the funds needed to float his business. Clients who have life insurance (including convertible term) and whose health has changed for the worse since they bought the insurance may have an opportunity to sell the policy for more than it's worth than if they surrender it.

Low Interest Rates

Low interest rates have had a profound effect on life insurance policy performance, except for variable policies. All other in-force policies that have policy



Richard L. Harris is a principal at Greenberg and Rapp Financial Group in East Hanover, N.J.

performance based in whole or in part on the performance of the insurance company's general account (the money the insurance company invests itself), including whole life (WL), general account universal life (UL), universal life with secondary guarantees (GUL) and equity-indexed universal life (IUL), are affected because with low interest rates, the insurance companies earn less on their investments.

Reserves. Insurance companies hold reserves in part based on the quality of the underlying assets. If a company's asset quality is low, it will have to hold more in reserves. Highly rated debt securities are important components of any insurance company's portfolio. Companies hold anywhere from 50% to 80% of their assets in those bonds. The asset portfolio determines how companies price products along with the performance of existing products. Lower interest rates change assumptions used in pricing new products and may impair the performance of existing policies.

Pricing of products. Lower interest rates can cause the premiums for UL and GUL policies to go up for new insurance because the low rates squeeze the profitability of companies. If your client is looking for lower premiums, consider IUL policies with secondary guarantees. Those guarantees are usually for 20 years or longer. Using a conservative earnings assumption, 70% of the maximum assumption, the chances of the policy lapsing before the intended date are remote. The premiums may be lower than those for GUL, and there will be cash surrender value available.

In-force policies. The dividends on existing WL policies and the performance of UL and IUL policies are affected by the low interest rates. Here's how: An insurance company owns a portfolio of assets. Assume that all the debt it owns comes due in one to 10 years and that the company invests an equal amount each year. Debt the company acquired 10 years ago pays a higher interest rate than debt acquired now. Assuming a straight line decrease in interest rates over the 10 years, as a debt instrument matures, the company must replace it with a debt instrument today that has a lower interest rate. If the interest rate 10 years ago was 7% and now it's 2%, the company gets 5% less on the new debt instrument. This affects the average rate of return of the entire portfolio. This calculation is called the "portfolio crediting method," which almost all insurance companies use. It will lag the interest rates in effect at any given time because of the investments that were made in the past. The average is always affected by those past investments as long as they're held. The insurance company credits interest on UL and sets cap rates (the maximum return that a policy can receive based on the performance of an index) on IUL based directly on those rates. Dividends on WL are somewhat affected as well. As can be seen, with higher interest debt being replaced with lower interest debt, the average goes down.

> Illustrations that were done when a policy was first issued aren't pictures of what's happening today.

IUL policies guarantee that regardless of how poorly the selected index performs, to the extent that it affects policy values, the percent credited can't go below zero. (The policy will lose value because of the expenses and cost of insurance taken out.) To do that, the insurance company has to set enough cash aside so that the zero return is achieved. Assuming that an insurance company's earnings rate is 4%, it would have to set aside a little more than $96 out of every $100 it receives to cover that guarantee. It purchases options (for example, puts and calls) to protect it if the index goes up. The maximum rate credited for a segment (insurance jargon for investments made in an index in any particular month until maturity) is determined by the index options that the company can purchase. If its option budget is 5%, it can buy options that produce a higher cap than if it only has 4% to spend. The insurance company will set a cap rate based on the rate of the options. (Cap rates change monthly and apply to each new segment created that month. That includes premiums received and the value of a segment that matures that month.)

Accordingly, illustrations that were done when the policy was first issued aren't pictures of what's happening today. Remember that an illustration is a projection of what will take place in the future if none of the company's assumptions change. They're invalid as soon as they're printed. And, because those portfolio rates, lagging the actual interest rates, will continue on

a downward trend, even if interest rates today start to go up, future returns will be more negatively affected. That's because if an insurance company, as required by the National Association of Insurance Commissioners Guidelines, makes a projection based on its returns now, its future returns will be lower. The portfolio rate today is higher than the portfolio rate next year. Unless a client asked for projections using lower rates than the assumptions used at the time the policy was taken out, the actual performance of the policy will be worse than was originally illustrated. If your clients are getting in-force illustrations today, because there will be further decreases in performance, they should ask for a rate lower than what's currently projected.

Practitioners should advise clients to review all existing split-dollar arrangements.

Split-dollar arrangements. Low interest rates also affect split-dollar arrangements (that is, one party pays the premiums for another and shares in the benefits of the policy). In 2001, the Internal Revenue Service issued Notice 2001-10, and in 2003, it enacted Treasury Regulations Section 1.7872-15, creating a new kind of split-dollar arrangement—a loan arrangement. All premium payments are treated as loans. The term of the loan can be whatever the parties agree to. The minimum interest rate without triggering adverse consequences is determined by the applicable federal rate (AFR) in effect for the term of the loan at the time the loan was made. Loans of three years or less use the short-term rate; loans from three to nine years use the mid-term rate; and loans for longer than nine years use the long-term rate. The regulations do something that can't be done in any other related party loan transaction—a loan can be made for the life of the insured. To determine the appropriate AFR, the insured's life expectancy is determined using the annuity tables under Treas. Regs. Section 1.72-9. If the insured's life expectancy is more than nine years, a loan for life uses the long-term AFR. In December 2020, the long-term AFR was 1.31%. For older insureds, it may be the mid-term or even short-term rate. Regardless of the term used, the interest rate for that loan won't change during the term of the loan.

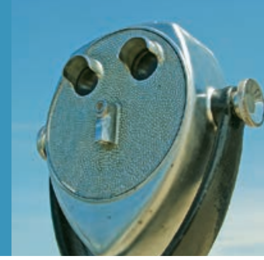
Practitioners should advise clients to review all existing split-dollar arrangements. All arrangements done before 2001 were economic benefit arrangements. As in all split-dollar arrangements, there are two parties: the party paying some or all of the premiums and the party that determines who gets the death benefit. In an economic benefit arrangement, one party *advances* (not loans) money to pay premiums in return for receiving back, in most cases, the greater of the cash value or premiums paid. The other party names the beneficiary for the difference between the face amount of the insurance and what the premium advancer is due. The value of the benefit is determined by the cost of annual renewable term insurance for that year at the insured's then age. In 2001, Treasury created Table 2001 to be used to determine that cost. The annual renewable term rate goes up every year as the individual gets older. If two lives are insured, the rate is based on the likelihood of both dying in the same year. When one of the insured dies, the cost is determined by the rate for the survivor, a much higher number. These arrangements can be changed to loan arrangements.

For clients with existing economic benefit arrangements, the interest due on the loan may be less than the taxable term cost. Compare the economic benefit of the receivable with the interest that would be due if the economic benefit arrangement was converted to a loan arrangement. One of my clients converted six split-dollar arrangements with an economic benefit of $120,000 to a loan with interest of $30,000. Because it's a loan for the life of the insured, the interest rate remains the same for the life of the loan. (You can convert to a shorter term loan if so desired. At the end of the term, the loan will have to be renewed at whatever rate is in effect then. Because the long-term rate is so low, I would strongly consider doing the loan for life.)

Be careful with grandfathered equity split-dollar arrangements. In that scenario, the premium advancer is only entitled to the premiums paid, and in most cases, the premiums paid are less than the cash surrender value. There's no tax on the accrual of cash value. As long as that arrangement doesn't change, the owner isn't taxed on the excess of the cash value over premiums paid. Changing to a loan arrangement is a material change that will force that taxation. It's taxed as ordinary income.

If your client has an existing loan arrangement, see if the current interest rate is lower than the rate on the existing loan. If so, it makes sense to roll the existing loan(s) into a new one for a new term or the life of the insured. If there are multiple loans, it will simplify the bookkeeping. Interest may be accrued instead of paid. One additional benefit occurs if the owner is a grantor trust, and the grantor is making the loans. Because of the grantor trust status, until the trust changes to a non-grantor trust or the grantor dies, there will be no original issue discount attributed to the accrual, eliminating any payments and any gift tax consequences.

Loan split-dollar arrangements are a good way of exiting a premium finance strategy. In a typical premium finance arrangement, a trust owns the life insurance and is the borrower. The cash value of the life insurance is used as collateral. The party setting up the trust (the grantor) guarantees the loan and puts up additional collateral if the cash value of the life insurance isn't enough to cover the loan. At some point, because of future uncertainties regarding interest rates, policy performance or the ability to be able to continue to get favorable loans, it behooves someone to end the arrangement. The grantor paying off the loan outright would be making a taxable gift to the trust, including interest paid and payable. A loan split-dollar arrangement obviates the gifting problem. It can also be done so that some of the loan is paid back with the cash value of the policy, but not so much that the policy will lapse in the future. The balance of the loan can be repaid using split dollar. Although it's now the grantor who's putting up the capital, because of the low interest rates today, the interest rate will be much lower than the interest rate of the financed arrangement. And ostensibly, the grantor may still have access to some or all of the loan if the cash value is enough to repay it without risking the policy ever lapsing.



By **L. Paul Hood Jr.**

Thirty-two Core Beliefs

Holistic ways for practitioners to achieve a good estate-planning result

At age 36, I was a cocksure lawyer who was confident that he'd seen it all and had all of the answers in estate planning. When challenged by an elderly client to start with my very best advice—the advice that I'd give on my deathbed—I had no immediate answer and realized that I'd never articulated my own estate-planning beliefs and philosophies, which, to me, was a glaring personal omission. I immediately took to remedying that situation by creating a one-page list of my beliefs and philosophies on estate planning. I've tweaked those beliefs over the last 20 years, but, by and large, they've stood the test of time. Having been out of full-time law practice since 2005, I continue to think and to write about the list. These are in no particular order of importance, as they're all equal.

I consider myself to be a purposeful estate planner. By "purposeful," I mean that I consider the client's total life picture and employ traditional and holistic means to achieve a "good estate-planning result." By "good estate-planning result," I mean a plan that achieves the client's goals, reflects the client's values and nurtures or at least doesn't harm the relationships of those who survive the client. Notice that there's no mention of tax elimination or minimization in that definition. Some clients' goals conflict with tax minimization; that's just a fact. Here are some of my core beliefs.

Listen to Client's Needs

The client is the one best suited to design the parameters of the estate plan—the estate planner should merely be a facilitator. Many clients come into the estate-planning process without a clear idea of what they want to accomplish or indeed what's even possible. Most practitioners assume that by the very fact that the client is in their office, the client is ready to proceed with estate planning. Years ago, I believed this. However, I learned the hard way that this isn't always the case. Too often, the client will ask the practitioner, "What do others similar to me do?" This is a loaded question.

It's seductive for the practitioner to then take over the process and pigeonhole the client into one of the practitioner's pre-fabricated estate plans that too often are drafted with a view toward tax minimization and to make the draftsman's post-death administration job easier. I believe this practice explains at least some of the procrastination by clients in estate planning and subsequent failure to go forward with signing the documents, especially when that pre-packaged plan conflicts with what the client actually thinks when finally confronted with having to make a decision about his estate planning.

I believe that the job of the purposeful estate planner is first to listen, watch the client's body language and ask open-ended questions to guide the client toward solving his own estate-planning problem. Too many practitioners begin talking way too soon before doing sufficient questioning, listening and watching. Listening to the client's needs isn't easy, particularly when the client is cost-conscious and puts the practitioner into the pressure-packed "expert category," which can be a conundrum and a trap. Every client is different; some clients know exactly what they want to do and can get right down to it, while others are unsure and meander. The purposeful estate planner needs to figure out where the client is in the estate-planning mental process and meet him there.

Give Client Control

The client must be in control of the planning process. Clients fear the estate-planning process, which can

L. Paul Hood Jr. is the director of planned giving at The University of Toledo Foundation in Toledo, Ohio

cause procrastination and failure to go forward. Death anxiety (mortality salience) is one of the obvious fears of estate planning. Clients also fear the unknown and not doing the right thing in the estate plan (so as long as they've done nothing, they haven't erred). Another fear is that the practitioner will take control of the client's estate-planning process.

Many practitioners, particularly those who have something to sell, are taught to gain control over the situation to close a sale by systematically eliminating each of the client's possible objections. The purposeful estate planner will do everything possible to put and keep the client in control over his estate-planning process.

Getting feedback from the proposed and potential beneficiaries can be invaluable in the final fashioning of the estate plan.

I maintain that clients who are in complete control of their estate-planning process go forward and conclude the work at a much higher success rate than those who let the practitioner control the process.

Mirror the Client's Goals

An estate plan must mirror the client's desires, goals and values—not those of the advisor. Too often, the practitioner is overly paternalistic and makes lots of decisions concerning the client's estate plan, often buried in the so-called boilerplate, which express the practitioner's desires, goals and values instead of the client's. Clients whose estate plans reflect their personal desires, goals and values are much more likely to have bought into the plan, are far more likely to sign documents implementing the plan and are usually happier and more confident about their estate plan.

Consider Psychological Implications

The client's legacy impacts far more than the client's property. Estate planning can have psychological implications for the receivers or perceived receivers and can adversely affect the relationships of those who survive after the client's death. It's imperative that the purposeful estate planner make it crystal clear to each client that what the client does in the estate plan can have a lifelong effect on others.

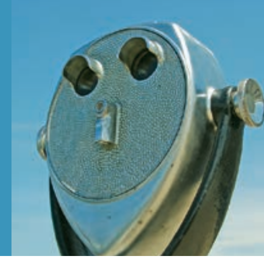
Get Feedback From Beneficiaries

Family communication before death is essential to an effective estate plan. One of the most common causes of miscommunication and estate and trust litigation is a client's failure to discuss his estate plans with potential beneficiaries. This dialogue goes a long way toward reducing the post-death rancor as well as relationship destruction. When heirs aren't given any explanation for an estate result that doesn't meet their expectations, they often default to hurt and anger, as they blame individuals who came out better and come back swinging with a vengeance in court. Often, there's a simple explanation that, had the client articulated it, either during lifetime or at death, would have cut off post-death litigation or hard feelings. One explanation could save thousands in legal fees and eliminate or substantially reduce angst and hard feelings.

This doesn't mean that those folks should necessarily have the right to give input or vote about the estate plan; estate planning shouldn't be a democracy. However, getting feedback from the proposed and potential beneficiaries can be invaluable in the final fashioning of the estate plan. The client may learn that the intended recipient doesn't want the legacy or may prefer it to go elsewhere.

This situation often plays itself out in family businesses. Parents too often, without asking their children, assume that the children want to continue the business. A candid conversation may reveal otherwise, so that the family business can achieve a sale of the business while the parent is alive, which usually provides a higher price than a post-death sale by disinterested and inexperienced children.

Those who won't be receiving what they may have expected can begin to heal or at least get over it after having heard the client's plan and its rationale directly from the client, which often substantially reduces or eliminates post-death challenges or poor relations going forward.



Beware of the Hidden Enemies

The hidden enemies of an estate plan are the "lack ofs:" liquidity, coordination, communication and diversification. Any of these deficiencies can spell doom for an estate plan or cause it to underperform. Having more than one of these enemies usually is disastrous for an estate plan. The lack of liquidity and/or diversification threatens estate plans financially, while the lack of coordination and/or communication can tear an estate plan apart from within. Too often, particularly in this post-probate world, estate planning is done in bits and pieces through execution of deeds, beneficiary designation forms and pay-on-death account forms. The client whose estate principally consists of one asset, for example, a family business interest, isn't diversified and faces the risk of a wealth setback if the business flounders for whatever reason, even one that's out of the client's control.

Even though there may be little that the client can do about being non-diversified and, in fact, the client may be wealthy because of having taken the risk of non-diversification, since reward usually follows risk, the purposeful estate planner will nevertheless advise the client about this risk. It's worth repeating that you can't have too much communication in estate planning, either between the client and his potential beneficiaries, or between the client and his advisors, as well as among the advisors themselves.

Be Flexible

An estate plan must be flexible and anticipate reasonable contingencies. The principal problem with most estate plans is that they're fixed in time and based on a finite, fixed set of assumptions. People can die suddenly, become incapacitated or fall prey to alcoholism or drug abuse. Financial fortunes can wax and wane. People marry and get divorced and marry again. Relationships are formed while others fall apart.

Estate and financial planners and fiduciaries die, retire or change firms. The purposeful estate planner will anticipate and address reasonably foreseeable events and build in safeguards should any of those events occur. For example, when selecting trustees for a trust that's expected to last for a long time, the purposeful estate planner will not only provide for successor trustees, but also will include a method for selecting additional successor trustees when the named successors can or will no longer serve. The client also should consider a family business succession plan when the client's estate includes a family business interest, and that business succession plan must be carefully coordinated with the estate plan.

Refrain From Absolutisms

There's no one absolutely correct way to address any particular estate-planning issue. Practitioners who fail to adhere to this principle fall prey to psychologist Abraham Maslow's admonition that the person who only has a hammer begins to think that every problem is a nail. Every client's situation is unique. Indeed, what may usually be lousy advice for most may fit a particular client's situation perfectly. The purposeful estate planner will remain nimble and open-minded about all possibilities for solving a client's problem.

Don't Assume Order of Death

An estate plan must work irrespective of death order. One of the immutable truths of life is that individuals sometimes die out of actuarially expected order. The estate plan that hinges on, for example, a senior generation member predeceasing those in younger generations often is a house of cards that comes crashing down when a member of the junior generation dies first. The same is true in the estate plan that assumes that a healthy spouse will survive a not-so-healthy spouse. This problem is seen in buy-sell agreements between those of different generations. The purposeful estate planner will draft an estate plan that still functions if deaths occur out of expected order.

Provide Checks and Balances

An estate plan should provide a system of checks and balances on power and authority. Estate planning necessarily involves a passing of the torch of leadership and control. As Lord Acton observed long ago, power tends to corrupt, and absolute power corrupts absolutely. Power shifts can expose people and leave them vulnerable to oppression, even to being terminated in employment or as a beneficiary through, for example, a spiteful exercise of a power of appointment (POA). The purposeful estate planner will build in a series of checks and balances that simultaneously allow exercise of authority and provide protection to those who are subject to that authority, which can be in the form of veto powers, powers to remove and replace trustees,

co-sale or tag along rights, accounting rights or similar types of protections.

Anticipate Post-Death Problems

If you foresee a challenge to the estate plan, discuss building a reasonably negotiated "out" for the potential contestant with your client. Otherwise, the only out is the courthouse. Wealthy individuals usually find that they have no peers down at the courthouse. The purposeful estate planner will plan in advance for realistically possible post-death problems and estate plan challenges. Sometimes, the fix is as simple as a modification of the spendthrift clause to permit voluntary purchases and sales of beneficial interests so that the interests of beneficiaries who can't get along in the same trust can be separated, which occurs frequently when step-relations are lumped together in the same trust.

Sometimes, if a challenge or other problem is anticipated, the estate plan can be confected to penalize the challenger or reduce the value of winning a challenge. For example, the estate plan might contain an in terrorem clause in which the challenger forfeits his inheritance by challenging the estate plan or can even be configured in such a way as to force the challenger to sue his own children (when a generation is skipped, usually to the chagrin of the members of the skipped generation) or even a respected charity to receive anything from the estate. Sometimes, it involves making what's potentially available to the challenger an undesirable asset, such as a minority interest in a closely held entity or even non-voting stock or an assignee interest in a partnership or limited liability company.

Sometimes, if a challenge or other problem is anticipated, the estate plan can be confected to penalize the challenger or reduce the value of winning a challenge.

Prepare for Post-Death Contingencies

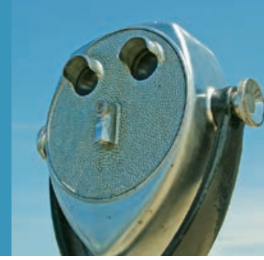
Estate planning is a process, not an event, that never ceases until at least nine months after the client dies. A prudent estate plan will provide for post-death contingencies. Too many clients and their advisors view estate planning as an event that ends when the will or trust is signed or the life insurance is purchased. The purposeful estate planner views planning as a process on several levels that continues throughout the client's lifetime. Estate planning often is done in stages: a will or trust is executed, or a deed is signed, which may or may not be done at the same time (even though it should all be coordinated). Because life always changes, it's imperative to review an estate plan periodically and modify it to address material changes in circumstances. I've advised clients to have estate plans fully reviewed every five years or immediately following a significant life event, for example, marriage, divorce or birth of a child.

I've also urged clients to pull out their estate-planning documents and read them once a year, either when going onto or coming off of daylight saving time. I've continuously reminded clients that it was their estate plan, not mine. The estate plan also should provide for what happens if one of the heirs, beneficiaries or legatees survives the client but dies during the administration of the client's estate. Moreover, the purposeful estate planner will draft an estate plan that anticipates and provides for disclaimers or failures to survive for a short period of time.

Coordinate Efforts Among Advisors

Coordination of efforts among the client's professional advisors is critical to the ultimate success of an estate plan. Communication problems among estate-planning advisors arise in one of two principal ways:

1. The client tells each advisor what the client feels that advisor needs to know and no more, so that the client retains some false sense of control over the situation. Communication among advisors can surmount this problem—if the advisors anticipate this possibility and fully communicate among themselves. I required complete access to all of the client's advisors in my engagement letter.
2. The advisors fail to properly communicate among themselves. Sometimes this happens because of fear that the other advisors will encroach on the advisor's



"turf," which causes that advisor to withhold information. Sometimes these communication problems are caused by a power struggle among the advisors to be the client's "most trusted advisor." Still other times, the problem is that the advisors don't trust, respect or like each other.

The problem is that the client and the beneficiaries of the estate plan are the ones who ultimately suffer. This suffering is avoidable if the advisors check their egos at the door and remain open-minded and cooperative and truly put the interests of the client first. The key to effective estate planner communication when multiple advisors are involved is collaboration and the willingness to acknowledge a good idea that they didn't come up with and spread the credit among all members of the team.

Beware of Misrepresentation of Facts

Information withheld from advisors is one of the biggest reasons for estate plan failure or underperformance. Very few estate planners do much due diligence aside from incorporating the answers from a client's fact finder, assuming those answers to be complete and truthful. The purposeful estate planner will maintain a healthy skepticism about the client's representation of the facts, paying particularly close attention to what isn't said or when things just don't add up.

Clients hold back some facts for various reasons. The client may feel vulnerable and want to maintain control by holding onto key facts. Sometimes, clients are embarrassed, rightly or wrongly, by what isn't revealed. Sometimes, a client is hiding something from his spouse or family and can't tell the advisor in front of them. On a few occasions, I uncovered some material facts that had been misrepresented, underrepresented or omitted. One ramification of misrepresenting or omitting material facts is that it gives a client a false, if not irrational, ground to disregard our advice when the client knows that the facts are other than what he represented, but the client can't say why he's rejecting the advice.

Apply Risk Management Principles

Apply risk management principles in the estate-planning process, and consider asset protection and investment diversification. Client families face different types of risks. Advise the client to take active steps to reduce or eliminate these risks. Estate planning has come full circle, from a time when there were ethical issues inherent in even discussing asset protection with clients to a time when failure to address it may well constitute malpractice. In the estate-planning process, employ risk management principles, including segregating high risk assets from passive investment assets. The purposeful estate planner should discuss appropriate asset protection techniques ranging from asset segregation in entities to proper property and casualty insurance, as well as umbrella insurance to self-settled asset protection trusts.

Asset Values, Cash Flow and Income

Significantly analyze asset values, cash flow and income before any gifting is done. Many estate planners focus too much on asset values and prospects for appreciation in the gifting calculus, and they don't spend enough time analyzing the cash flow aspects of a proposed gift. If the planner doesn't sufficiently consider cash flow aspects, the client could be left exposed after having made a large irrevocable gift. For example, a client who's still working in a family business and living off of the salary of that business may be best advised not to gift significant interests in the business entity because the loss of control could imperil his livelihood. I've seen good and fair offers to buy family businesses get rejected when the client realized that his share of the post-tax sales proceeds after the large gift of interests wouldn't support his lifestyle at the same pre-sale salary level, often to the family's detriment because the time was right to sell and the price was attractive.

No Need to Force Inter Vivos Gifts

It's okay not to want to gift property. Many practitioners are mesmerized by the tax and estate-planning benefits of inter vivos gifts. Some pressure clients to make gifts to achieve these so-called "benefits" under the guise that gifting is something that they can't afford not to do. Practitioners like these neglect to consider the loss of access to the capital that the gifted asset represents. It's the nature of human beings to gather and accumulate possessions. What isn't so natural is to part with significant assets during lifetime because of the real fear of running out of money or living too long. The purposeful estate planner recognizes this difficulty and allows the client to become totally comfortable with irrevocably

parting with significant assets before allowing the client to do so, notwithstanding the potential tax benefits of gifting, never forcing a client to make a significant irrevocable gift.

Don't Assume It's Too Late

It's rarely too late to do some planning. While it's true that some estate-planning techniques are risky at the end of life expectancy or after the client becomes terminally ill, there are many things that can be done to assist the effectiveness of the client's estate plan even at the end of the client's lifetime. For example, asset holdings can be rearranged to qualify the client's estate for tax benefits, such as paying the estate tax in installments. It's

Illiquidity is an enemy of the estate plan unless it's carefully planned out in advance.

appropriate to revisit beneficiary designations and the estate-planning dispositive documents close to the time of death to see, for example, whether POAs should be exercised.

Don't Ignore Boilerplate

Boilerplate is more important than you think. Practitioners make very important decisions that are buried in the boilerplate of documents. The purposeful estate planner will carefully review, with a fresh mind, his boilerplate for every client to ascertain what items to discuss so that the estate plan more carefully mirrors the goals and desires of the particular client.

Don't Force Equal Treatment

Fair isn't always equal; equal isn't always fair. Many clients slavishly adhere to the principle of treating children equally. Often, it's the children who remind and pressure clients about this; I call this the "what about me?" syndrome. The purposeful estate planner will point out to clients that leaving estates equally to children isn't always a fair result, particularly if one child is needier than other children or when the client helped one child far more during lifetime than the other children.

Build on Bridges of Trust

In my experience, the best estate plans involved an element of intergenerational trust in passing on the torch of leadership. How does one engender that trust? It's simple to articulate, but is sometimes difficult to put into practice. At some level, it involves a surrender of some control by the senior generation. But, it also requires the younger generation to be circumspect, respectful and magnanimous about the use of that received power and control. Building safeguards into the estate plan in the form of checks and balances on authority can assist greatly in the building of this bridge of trust. This can be seen in the common installment sale to the junior generation in exchange for a promissory note, so that the senior generation's interests are adequately protected through security devices such as pledges and/or mortgages.

Carefully Select Fiduciaries

Carefully consider choices of executors, trustees, agents and officers, including backups, advisors and alternate choices. Don't overlook institutional trustees. The best laid estate plans can be torn asunder if the wrong people are put in charge. The purposeful estate planner should caution clients not to pick fiduciaries who'll have an inherent conflict of interest without instituting adequate safeguards. For example, the agent under a durable power of attorney should have to account to someone after the principal's incapacity, because without such protection, suspicious family members may try to intervene with some sort of court proceeding such as conservatorship. That agent under a durable power of attorney generally shouldn't serve as sole executor of the principal's estate or as successor trustee of the principal's trust because that would mean that the agent's final accounting would be to himself, which is a conflict of interest.

Selection of fiduciaries also can inform what powers are given to each fiduciary. And, there may be express limitations on the exercise of certain rights and powers by certain fiduciaries. For example, in a blended family situation in which the client's estate plan includes a significant bequest or provision for children, it's often appropriate to limit the powers of an agent under a durable power of attorney to modify that estate plan by, for example, modifying trusts, exercising POAs or discontinuing a client's pattern and history of gifting. In blended family situations, I provided for affirmative and negative constraints on the power of

an agent under a durable power of attorney when the agent only represented one side of the client's family, for example, a spouse or partner or a child.

Avoid Restrictive Trusts

Trusts are management vehicles—they shouldn't be more restrictive than necessary. All other things being equal, all assets should be held in trust. Because life can turn so quickly and be unpredictable, I recommend that all assets be held in trust absent a compelling reason to do otherwise. However, the trust instruments themselves should give flexibility to the trustee to react to changing circumstances, particularly if something bad happens to the client. And, beneficiaries can and should serve as co-trustees in most situations in which they're competent and able to do so. Trusts can be used simultaneously as wonderful teaching opportunities, as well as effective asset protection devices, which can protect the client from former spouses and other predators.

> Making appropriate referrals is a sign of wisdom and strength, not weakness or inadequacy.

Consider Special Situations

Some situations warrant special attention, for example, when less than all of the client's children work in the family business; when the client contemplates separating the building from the family business by bequest or sale; and in all subsequent marriage situations, especially if either spouse has children from a prior marriage or relationship—even if relationships now are good. These enumerated situations require special attention because of their inherent complexity. For example, in a subsequent marriage situation in which the client has children who aren't the children of the client's current spouse or partner, the estate plan should protect all sides after the client's death, which is when superficially good relationships often break down.

Provide for Sufficient Liquidity

Estate-planning documents don't pay taxes or debts—dollars do. An estate plan must provide for sufficient liquidity to pay taxes and expenses at each death. Illiquidity is an enemy of the estate plan unless it's carefully planned out in advance. Too often, second-to-die life insurance is used as the liquidity vehicle, but this ignores the taxes, debts and expenses that either could be paid or that are due or otherwise payable at the first death. Liquidity is an advantage for a properly crafted estate plan. For example, suppose the estate has an asset in it that's valuable but that's expected to significantly appreciate during the surviving spouse's life. It may be far better to forego a qualified terminable interest property (QTIP) marital deduction and pay tax on a lower number at the first death, but this isn't possible without a liquidity plan for the first death. Having sufficient liquidity at both deaths gives the heirs and fiduciaries more options.

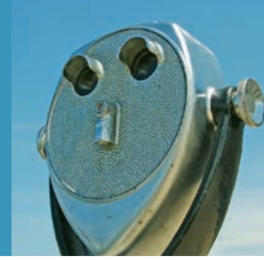
Don't Focus on Tax Considerations

Tax considerations shouldn't drive an estate plan. Estate planners often focus too much attention on the estate tax considerations and spend too little time on the more important and often more vexing non-tax issues. The tax issue is the easiest piece of the puzzle to solve in estate planning, which is why many estate planners want to stop there: It's the path of least resistance. The sad fact is that delving into the non-tax aspects of an estate plan often falls out of the bailiwick and comfort zone of some advisors and can get sticky.

The purposeful estate planner will assist the client in crafting a plan that meets with the client's goals and values, even if it costs some tax at death. I recall several situations in blended family estate planning in which the client simply wanted to divide his estate equally between his current spouse and his children from a prior relationship, even if it increased the total amount of estate tax due because of the reduction in the marital deduction and the estate tax apportionment in the client's estate. As long as the client is aware of and signs off on it, the estate planner should feel comfortable with proceeding in that fashion. The bottom line is that the estate plan should reflect the client's desires, goals and values.

Don't Always Defer Estate Tax

It sometimes makes little sense to defer the estate tax. Taking this action was more important when the estate tax applicable exclusion amounts were much lower and the rates were still graduated, because it often cost more



in overall estate tax to defer the estate tax through the marital deduction, when all that transfer would do is push the surviving spouse into a higher estate tax bracket; the Internal Revenue Service came out better if the estate of the first spouse to die elected to defer the tax through the marital deduction. Even in this time of high applicable exclusion amounts, only one effective rate and portability, it's important in my judgment not to knee-jerk defer the federal estate tax in every situation.

For example, if you have a marginally taxable estate that has an asset in it that's expected to significantly appreciate in value, it may make more sense to employ a credit shelter trust and pay some estate tax at the first death, with the trust funded with that asset, which will get the asset out of both estates. If the asset is allocated to a QTIP trust and portability is elected, the appreciation may turn out to exceed the available applicable spousal exclusion amount, which will trigger estate tax at the second death, which could have been avoided through proper planning at the first death.

Give High Basis Assets

Lifetime donations to family, especially of cash or other high basis assets, can reduce estate taxes, if your client addresses the cash flow considerations. The most important consideration in deciding how to advise a client concerning gifting is an analysis of the cash flow issues both pre- and post-gift. Parting with asset value is one thing, but parting with cash flow from the asset is quite a different kettle of fish. The client must be comfortable with that loss of cash flow, and, just as importantly, the loss of access to the capital that the gifted asset represents, that is, the power to sell or mortgage the property. All other things being equal, it's best to gift assets that are expected to appreciate, but not necessarily when it's likely that the donees are expected to sell the asset shortly thereafter, especially if that asset has a low tax basis in the hands of the donor, who simply passes that low basis on to the donee.

Don't Ignore Income Tax Aspects

They're often more important than estate tax considerations. With the higher applicable exclusion amounts and talk in the air of outright repeal of the estate tax, thankfully, most advisors have started focusing attention on the income tax ramifications of the estate plan because very few clients have to worry about the federal estate tax. But, the income tax aspects of estate planning have always been very important. For example, if the client is charitably inclined and has an individual retirement account or qualified plan, the client should strongly consider satisfying the charitable portion out of the IRA or qualified plan pre-tax assets with post-tax assets because the charitable recipient is exempt from income tax while family members aren't. The differences in the adjusted basis rules for inter vivos versus testamentary transfers can make a huge difference in the after-tax proceeds of a sale of an asset.

Require Charitable Intent

Charitable estate-planning tools require charitable intent—these tools rarely provide a better economic result than making no charitable gift at all. Very few things can get a practitioner in more hot water than trying to shoehorn a non-charitably inclined client into a charitable technique under the guise that it produces a better economic result. For example, charitable remainder trusts (CRTs) used to be marketed so that the client's income tax charitable contribution deduction was "invested" in a life insurance policy that was to make up to the client's family what the charity received at the end of the CRT term. I've found that this was seldom true, as the life insurance almost always cost more than the tax savings from the charitable

SPOT LIGHT

In Full Bloom

At the Far Edge of the Universe (part of a set of eight prints) by Marc Quinn sold for $20,200 at Sotheby's recent Prints & Multiples auction in London on April 4, 2017. Quinn has an ongoing project, titled *Self*, in which he creates a frozen sculpture of his head using five liters of his own blood. He creates a new sculpture every five years to document his aging and deterioration.

deduction, particularly when the client couldn't fully use the entire charitable deduction. In these situations, all you would end up with is an unhappy client, unless there's true charitable intent buttressing the transaction. There's no substitute for true charitable intent on the front end. Estate planners have been successfully sued for this mistake. Don't make this error. Steer non-charitably and even marginally charitably inclined clients away from charitable techniques.

Get Complete Appraisals

Gifting (or selling to family) without full-blown, complete appraisals by qualified appraisers invites tax disaster. I realize that clients hate to pay appraisers and often only begrudgingly do so because you told them that they had to, but the purposeful estate planner will be firm about this necessity. In tax valuations, actual value is irrelevant because it's the tax return value that's important, and that value may have no relation to true value. Actual value is unknown because there usually hasn't been an arm's-length sale at fair market value, and perceived, defensible value is everything. Only a comprehensive appraisal performed by a qualified, independent appraiser can protect the client from the vagaries and sometimes arbitrary and capricious valuations of the IRS, as well as the associated expenses and risk of having to defend value.

Consider Total Situation

An estate plan must consider the client's total situation—personal and business relationships, values, health care, management, property disposition, liability exposure, liquidity and cash flow needs and taxes. Too often, practitioners just want to deal with a limited aspect of the client, usually the property and the taxes, but this does the client and the practitioners a grave disservice. The true practitioner will see the client as a complete person, who's comprised of many related parts, and will address all of those parts. In today's extraordinarily litigious world, it's imperative that the practitioner review the client's assets and lifestyle for liability exposure and consider ways either to eliminate or reduce that exposure.

Liquidity should be viewed as much a separate asset as illiquidity is a liability. Insurability at standard rates also should be viewed as an asset that usually doesn't last forever. There will be plenty of situations along the way in which the client or someone in the client's sphere needs services that the practitioner either doesn't provide or can't provide. The purposeful estate planner will be circumspect about his professional limitations and not be bashful about recommending that the client engage other professionals to help when the need is outside of the his purview. Clear examples of this are in family business consulting or wealth psychology. Sometimes, the client's family is stuck in conflict and needs a trained facilitator who's educated in family systems theory. Making appropriate referrals is a sign of wisdom and strength, not weakness or inadequacy.

SPOT LIGHT

Puzzling

Design for London Underground Mosaics by Sir Eduardo Paolozzi sold for $13,992 at Sotheby's recent Made in Britain auction in London on April 5, 2017. The featured painting is the "blueprint" of the iconic mosaics created by Paolozzi at the Tottenham Court Road tube station in London. Completed in 1986, 95 percent of the installation has been retained following a recently completed renovation.

By **L. Paul Hood, Jr.**

The Human Side of Estate Planning: Part 1

Understanding the psychological issues can help achieve a good result

The estate-planning process is difficult for many of our clients. Clients usually have a lot at stake financially and emotionally when they engage an estate planner. The fact that others often have an intense interest in the outcome of estate planning doesn't make planning any easier for the client or, for that matter, the estate planner.

Further complicating matters is that there's usually a wide gap between the knowledge of estate planning that the estate planner possesses compared to that of the client. This disparity adds to the client's perplexity because it can create feelings of helplessness and dependence.

What does this wide gap in knowledge mean? The estate planner is in a unique position of confidence, looked to as "one who knows."[1] There are legal and psychological burdens that come with this position. What makes this even more difficult is that the client often cedes the power over the process to the estate planner. How many times have your clients asked you, "What do you think I should do?" Estate planners risk fashioning themselves as rescuers, the client's knight in shining armor. There's also a seductive opportunity for the estate planner to take on a role as omniscient and omnipotent, which is a grave error that many estate planners make.

Proper Role

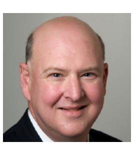
Consider the following question: What's the estate planner's role in the estate-planning process? To do exactly what the clients say that they want? To educate clients? To be a zealous advocate for the clients? To be the messenger of mortality? To assist clients in transmitting their property with the lowest possible tax consequences? To help clients put together a legally binding estate plan that can withstand attack by disgruntled third parties?

It's probably some or all of the above. Surely, the estate planner should refrain from being just a pawn of the client. However, the estate planner who focuses on the transfer of property with minimum tax consequences is abdicating part of his counseling responsibility to his client. There's a big difference between being an estate planner in the truest sense of the term and an estate or tax technician. Despite the misgivings of the late trusts and estates attorney Joseph Trachtman of Hughes, Hubbard & Reed in New York and Professor Thomas Shaffer of Notre Dame Law School in Indiana about the term "estate planner" (instead of the term "lawyer"),[2] being an estate planner is a far nobler calling than "estate technician," as the term now applies to non-lawyers as well.

Good Estate-Planning Result

Every estate planner and client should be in pursuit of a good estate-planning result, whatever that is for that particular client. What's a good estate-planning result? While estate planners certainly can quibble with the answer to this question, it's been shown that good results don't happen nearly as often as they should.[3] Probate and trust litigation is on the rise, as people discover that Mark Twain was correct: You never really know someone until you share an inheritance with them. Elder financial abuse also is sharply up, which inevitably leads to undue influence claims. Why? And, what can we estate planners do about it? We can do a lot if we placed more emphasis on our counseling function.

I define a "good estate-planning result" as one in which property is properly transmitted as desired, and family relations among the survivors aren't harmed during the estate-planning and administration process.



L. Paul Hood, Jr., based in Toledo, Ohio, is an author and frequent speaker on estate planning

Notice that conspicuously absent from this definition is any mention of taxes. Taxes have always been the easiest piece of the estate-planning puzzle, yet the overwhelming majority of estate planners still focus their attention almost solely on the tax piece, probably because it's easiest to solve and easiest to demonstrate quantifiable, tangible results.[4] This misfocus has contributed to several problems for planners and clients alike.

Over focus on taxes has resulted in the commoditization of estate-planning services, as estate planners joust over who's developed or who uses the best tax planning mousetrap, which has led to a sharp increase in do-it-yourself one-size-fits-all estate planning. For the myopic tax crowd, the jig is up, courtesy of Congress, which has essentially repealed federal transfer taxes for all but a few thousand people.

The Path

The model, entitled the "Path of Most Resistance" (the Path), p. 54, represents an attempt, feeble and amateurish as it may be, to depict why a good estate-planning result is so hard to achieve by focusing attention on the obstacles in its path. I began tinkering with creating such an explanatory model back in the mid-to-late 1990s, and it's evolved a bit over time. However, its basic structure has remained intact since its inception.

As the Path illustrates, there are several players in the estate-planning play. I realize that most clients have more than two estate-planning professionals or advisors assisting them, but the larger point is that having more than one advisor itself creates potential obstacles in the path toward a good estate-planning result. Space and complexity of illustration caused me to use two advisors as a surrogate for the reality that the client may have three or more advisors who are attempting to render services to the client and the client's family. The same is true for the last category of receivers and others, when one is used as a placeholder for as many as the client has to consider. I purposely chose to use only one client even though spouses often do joint estate planning because each individual must separately negotiate the obstacles in the path of a good estate-planning result.[5]

Fiduciaries and trust protectors are included in either the intended beneficiaries or advisor categories. In this era of increasing slicing and dicing of fiduciary duties in vehicles like directed trusts, the role of fiduciary and trust protector can be vastly different from situation to situation.

In the Path, the items above the orange arrow represent views and common experiences in the past with life

> Self-awareness of your own feelings and past experiences can go a long way toward identifying and dealing with feelings.

and estate matters among all of the players. The items below the orange arrow are witnessed in each of the respective players in the estate-planning play. The Path is intended to illustrate that many things must happen for a good estate-planning result to occur. That is, there are lots of moving parts and opportunities for the process to go awry. The Path also illustrates that the planning process can go backwards too if the wrong events occur at the wrong time.

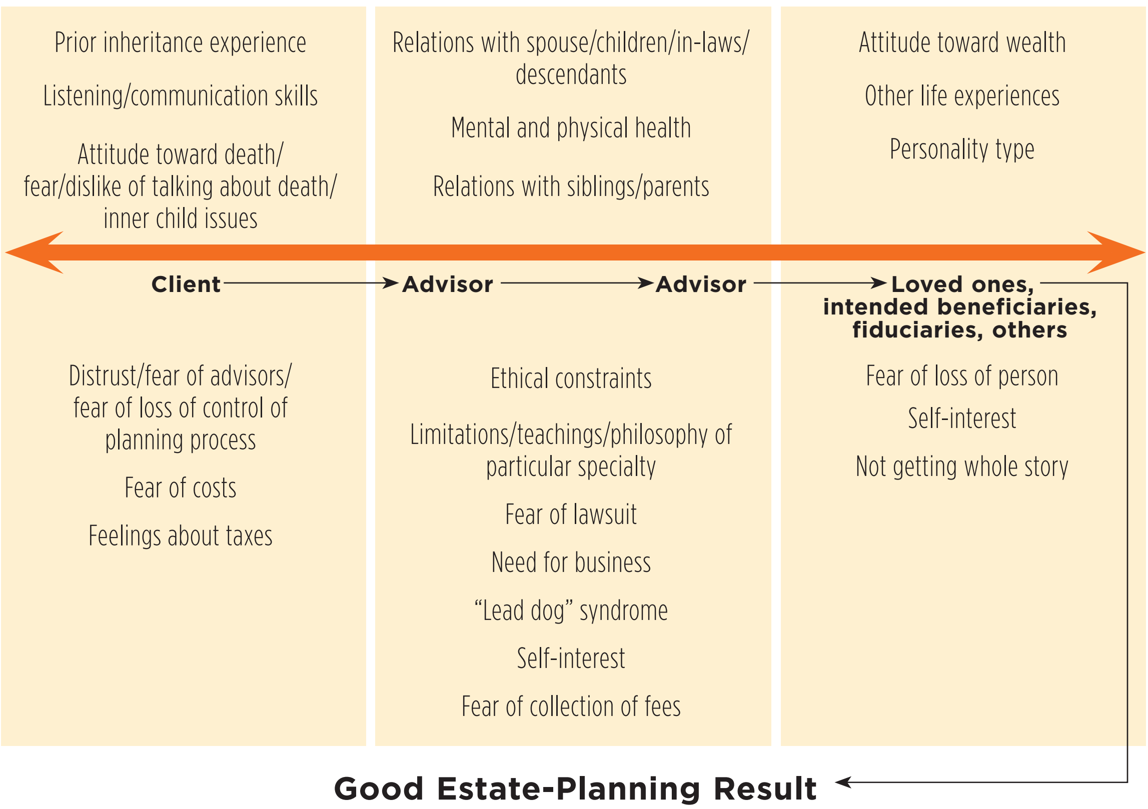
Behind the Scenes

Some past experiences are common to all of the players in the estate-planning play. These are set out above the orange line.

Prior inheritance experience. Past personal experience as an inheritor, fiduciary or beneficiary can go a long way toward informing one's views on wills, trusts, probate and estate-planning advisors. This past experience applies to estate planners too. People who've survived a contested trust and estate matter often are more guarded, even jaded a bit, by the experience. People who have no experience with trusts and estates matters are frightened of them, often because of horror stories that

Path of Most Resistance

Obstacles to achieving a good estate-planning result



— L. Paul Hood, Jr.

they've heard from others. Nevertheless, this past experience impacts how people think.

Tip: Pre-death intergenerational communication can go a long way to reducing rancor in trust and estate administration in large part by properly setting the expectations of the receivers. Once the client has died, the purposeful estate plan will be administered with complete transparency and frequent communication to minimize things going off the rails.

Listening/communication skills. Most people think that they're better listeners than they are.[6] Some people are more verbal than others, while others are more visual. Because a significant part of communication is body language,[7] it's very important to watch the other conversant's body language.[8] We all have different styles and levels of skill in both listening and communication.[9] It behooves an estate planner to be familiar with listening and communication styles so that he can better serve his clients and work collaboratively with other estate planners.

Tip: The purposeful estate planner should maintain solid eye contact with the clients during the interview, particularly during times of tension or points when there's some uncertainty, angst or disagreement.

Attitude toward death/fear or dislike of talking about death. Human beings are unique in being able to think about death, but most people would rather not think about it—their own or that of anyone else. Some

people simply can't consciously contemplate their own demise, which can be an obstacle in estate planning. Again, estate planners aren't immune to this; most estate planners are just as reluctant to discuss a client's future death as the client himself because this discussion reminds the estate planner of his own mortality.[10]

Tip: Consider taking the lead on being vulnerable and discussing death openly and honestly. It's okay not to like talking about death and be fearful of it, but fears faced out in the light tend to dissolve or be significantly reduced.

Inner child issues. Many people can trace or at least attribute a problem to something in their childhood. Author John Bradshaw[11] has written extensively about how childhood wounds manifest themselves as we age. It's important for estate planners to understand that some adult actions, particularly actions that seem negative or over reactionary, may have their genesis in childhood, particularly in working with family businesses.

Tip: Practice mindfulness and being more self-aware of your feelings and past. If an interaction or exchange with a client or another player brings up feelings within you, first label those feelings and then attempt to find their source.

Relations with spouses/children/in-laws/descendants. When I happily reported the birth of my first child to one of my mentors in estate planning, the late Gerry LeVan, he told me that he was halfway toward becoming a good estate planner, but that he wouldn't become a good estate planner until his first grandchild was born. Gerry was right. Indeed, after the birth of my first child, I began looking at documents that I was drafting differently and shifted many of my default provisions quite a bit, just because of the birth. My son's birth made me a better estate planner because I could now more readily empathize with parents. Some people have precarious relationships with family members, and divorce often creates more acrimony as the former spouses often force their loved ones to take sides.

Tip: Again, self-awareness of your own feelings and past experiences can go a long way toward identifying and dealing with feelings.

Mental and physical health. It's undeniable that the health—mental and physical—of everyone in the estate-planning play impacts the estate-planning process. People who've had brushes with death often are far more appreciative of each day of life than those who've been healthy for their entire lives. Mental health issues often lurk in the shadows of codependency and enabling, when some family members look after other family members, often to the detriment of both, and apologize and cover for the sick family member. This is particularly rampant when a family member suffers from drug and alcohol addiction.

Tip: We're all different and have different past experiences. Status of our physical and mental health significantly impacts our bandwidth and outlook on life. Age factors in here as well. Be aware of your feelings about physical and mental health, which often are informed by your past experiences.

The purposeful estate planner will insist that the client be in full control of the estate-planning process, with the estate planner acting as guide and counselor.

Relations with siblings/parents. Clearly, one's relationships with one's own siblings and parents, whether living or dead, have an effect on how one views relations of others with their siblings and parents. Contrast the "one big happy family," whose members truly love and respect each other, both the good and the bad, with the dysfunctional family whose communications have broken down, and the members have taken sides and gone into battle station mode.

Tip: Be aware of these relationships and how they've informed your views on estate planning for your clients.

Attitude toward wealth. Some people inherit significant wealth or are raised in affluent homes, while others grow up under less fortunate circumstances. These experiences often affect attitudes about wealth. Some are jealous, while others are oblivious to what other people's experiences are regarding wealth. Some people understand the value of hard work and savings, while others feel entitled to wealth. Inheritors may not view their wealth as their own because they didn't create

it. Contrast that with the individual who created the wealth, whose very persona often is inextricably intertwined with that wealth.[12]

Tip: It's important to figure out how the family came into their wealth because that will give clues as to how the wealth is perceived and how it will be administered and passed on, especially if the wealth wasn't created in your client's generation.

Other life experiences. This catch-all category can include bankruptcy, termination of employment, being a defendant in a lawsuit, jail, tax problems and divorce. The purposeful estate planner won't forget that these potentialities may be present and impact the client's decisions.

> It's perfectly acceptable to require a client who's asking for a lot of work to be done to put up a retainer in good faith to cover the work.

Tip: Your initial client questionnaire must ask some broad general life experiences questions, because, for example, the client who's gone through a nasty divorce or a bankruptcy may be far more guarded than the client who hasn't had these experiences.

Personality type. While everyone is unique in some respects, there are recognized personality patterns.[13] Some personality types blend well with others, while other types don't.

Tip: Make yourself familiar with personality types, because this knowledge will prove invaluable in getting through to clients of all types. Again, self-awareness is the key.

The Client

Clearly, the star of our play is the client. As stated earlier, some clients have significant experience with estate planning, but for many, this trek is a maiden voyage.

Distrust/fear of advisors/fear of loss of control of planning process. Clients often are novices in dealing with advisors, although some may have significant experience. Fear of loss of control of the estate-planning process keeps many more from tending to their planning than most estate planners realize.

Tip: The key is humility on your part and the willingness to let the client be in control of the process. I realize that this tact flies in the face of some sales training that teaches how to gain control and eliminate objections. However, the purposeful estate planner will insist that the client be in full control of the estate-planning process, with the estate planner acting as guide and counselor.

Fear of costs. Given that many estate-planning clients possess little experience in dealing with advisors, it isn't unusual to see people put off their estate planning simply out of fear of the cost.

Tip: Don't live and die by the time sheet, which was a terrible development because it attempted to quantify value through increments of time. The problem is that value and time aren't co-linear. A planner can render splendid advice in minutes that saves a client millions of dollars. On the other hand, spending five hours at your hourly rate on a routine will drafting assignment isn't going to make a client very happy unless the bill is significantly adjusted downward. Talk about fees up front and periodically. Put things in writing. Use flat fee arrangements when appropriate.

Feelings about taxes. While the federal estate tax under current law applies to a very few, although a number of states still have a significant estate tax, feelings about estate taxes often occupy a client's mind. Some people are hell bent on paying no estate tax, while others recognize that they won't personally ever have to pay their own estate taxes.

Tip: Most estate planners are pretty quick to point out that typically, no federal estate tax will be due (no doubt in some substantial part to their excellent work), so nothing further need be said here.

The Advisor

As stated earlier, the Path depicts two advisors but isn't intended to imply that a client may not have more than two. The more advisors, the greater the risk of more problems because when more people are involved, they bring more personal experiences and baggage into the situation.

Don't misinterpret what I'm saying here: The client should have as many advisors as he feels is necessary or appropriate. I'm a big believer in referrals and collaboration simply because it was my experience that clients get better service and a better estate plan. However, having more advisors creates a situation that must be watched and managed. I've seen estate-planning engagements fall apart because the advisors were incapable of cooperating and collaborating, which is a bad result for the client and can add to the negative experiences that the client will take to the next advisor, if any.

Ethical constraints. Each of the estate-planning subspecialties have their own ethical rules and conventions. These ethics rules impact subspecialties differently. The legal ethics rules insert some additional complexities in the estate-planning process, particularly in the areas of confidentiality and conflicts of interest. It's imperative that the planner's engagement letter permits complete and total access to all of a client's advisors.

Tip: Make sure that the engagement letter casts a wide net over the people with whom you may communicate to allow you to communicate with those third parties. That list could include children or other descendants, family business employees, lawyers, CPAs, investment advisors, fiduciaries (trustees, etc.), financial planners, life insurance agents, wealth psychologists and, in some cases, access to the client's treating physician.

Address fears and feelings head on with transparency.

Limitations/teachings/philosophy of particular subspecialty. Each estate-planning subspecialty brings its own mindset and philosophy into an estate-planning engagement. This often is clearly reflected in the factfinders of a particular subspecialty, which tend to focus more attention on the areas covered by that particular subspecialty. For example, lawyer factfinders tend to focus attention on property, while life insurance factfinders might focus attention on life insurance. Moreover, different advisors in the same subspecialty may have vastly different philosophies about estate planning. It's critical that advisors check their egos and biases at the door before getting down to work with an open mind and collaboratively on a client's situation.

Tip: Try true collaboration just once. If it goes right, you'll never want to work any other way again. With collaboration comes diversity of professional backgrounds, educational and experiential pedigrees; different manners of training; and significant knowledge about a certain aspect of the client's estate plan. This diverse strength of the group exceeds the strength of the sum of its individual members. This excess is called synergy.

Fear of lawsuit. Every professional advisor lives in some fear of being sued by a client. Estate-planning

SPOT LIGHT

Story Time

Peter Rabbit and His Friends by Harrison Cady sold for $10,625 at Swann Auction Galleries' Illustration Art sale in New York City on June 5, 2018. Cady is an American illustrator and writer best known for his *Peter Rabbit* comic strip. Here, Cady depicts Peter Rabbit for the April 1926 cover of *People's Home Journal*.

advisors practice defensively to minimize the risk of lawsuits. Some of these defensive actions negatively impact the relationship with a client, particularly when the client doesn't appreciate the risk of a course of action that the advisor recommends.

Tip: Again, one thing that most estate planners do well is practice defensively. I can only repeat nationally recognized estate-planning attorney Howard Zaritsky's sage and timeless advice to simply be nice.[14] To everyone. Lawyers are notorious for not being nice.

Need for business. Many advisors constantly search for new business. In a way, this is the flipside of the fear of lawsuit discussed above. Some estate planners

Intergenerational estate planning is best.

are better at giving safe "yes" answers to clients, who always want to hear "yes" and loathe hearing "no." Unfortunately, some estate planners spend an inordinate amount of time telling clients "no" when there's a safe "yes" answer that simply requires fresh thinking.

Tip: The safe strategy is to view potential clients cautiously in that they could be either an opportunity or a curse. Some clients are more trustworthy than others; some clients are more aggressive than others. Sometimes, estate planners who are worried about their level of business will take in just about any client, when a more selective policy makes far more sense.

"Lead dog" syndrome. Some advisors, particularly those with some product to sell, are trained to gain control of a situation. This behavior often conflicts with other advisors, especially those who also desire to be in charge of the client's estate planning. When advisors joust for the desired position of quarterback on the estate-planning team, it can delay or even end the planning.

Tip: Be a good example to those with whom you're supposed to be collaborating by keeping your ego in check and inviting them to do the same.

Self-interest. Let's face it, advisors are in business for themselves and have families to feed or employees to pay. Even though just about every subspecialty of estate planning has ethical responsibilities to clients, it would be foolhardy to expect advisors not to act in their own self-interest at some point in an engagement.

Tip: Put the interests of your client first.

Fear of collection of fees. This fear differs greatly from subspecialty to subspecialty. When an advisor commences an engagement without having first secured payment for services, this fear can impact how much work the advisor will do before being assured of being compensated, which can impact the venture toward the

SPOT LIGHT

Everybody in the Pool

Summer Camp Swimming Lesson by Abe Birnbaum sold for $2,210 at Swann Auction Galleries' Illustration Art sale in New York City on June 5, 2018. This image was the Aug. 21, 1954 cover of *The New Yorker*, for which Birnbaum frequently illustrated. This particular painting was done in oil pastel, gouache and ink on paper.

good estate-planning result.

Tip: It's perfectly acceptable to require a client who's asking for a lot of work to be done to put up a retainer in good faith to cover the work.

Loved Ones/Intended Beneficiaries

This category includes those who believe that they'll receive something from the client at death.

Fear of loss of person. Most people who have a potential interest in a client's estate have a relationship with the client. Quite often, these people fear the client's death as much or even more so than the client or the client's advisors. In fact, I've witnessed this fear be so palpable that, when expressed, it ended the client's estate planning because the mere notion of the client's death was too great to bear for the family member. The family member's horror at the mere notion of the client's death was triggered by the family member's fear of loss of the client. The family member acted out much like an infant whose parent leaves his side.

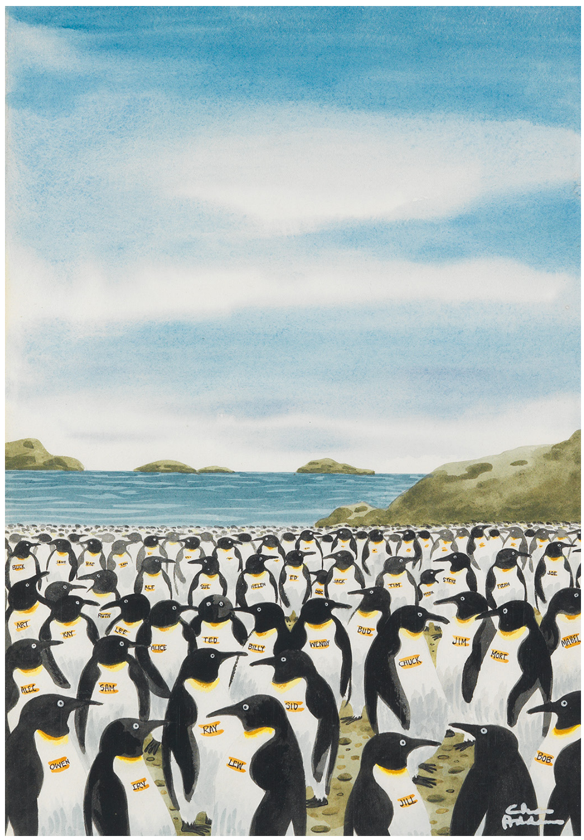
Tip: Address fears and feelings head on with transparency. Intergenerational communication is important in the quest for a good estate-planning result.

Self-interest. As with the advisors, we should expect people in this category to act or argue out of self-interest. There's nothing inherently wrong with looking out for one's best interests until it crosses the line and becomes either undue influence or even outright misappropriation.

*Tip***:** Many lay fiduciaries make big mistakes by failing to see the difference between owning property outright and holding the legal title to that property in trust and as trustee for the benefit of someone else. This is when the estate planner must clearly and, if need be, forcefully, inform the client that being a fiduciary is a potential source of great liability.

Not getting the whole story. I've found that intergenerational estate planning is best when the client communicated the estate plan and the reasons for it to the potential receivers during the client's lifetime. Nevertheless, it was far more common for clients to keep quiet about their estate plans during lifetime, despite my advice to the contrary. Some of the saddest and most unfortunate situations I've ever witnessed was when a deceased parent left a smaller amount to a child than what the parent gave to the child's siblings without explaining why this was done.

Quite often, this unfortunate and inadvisable practice leads to post-death administration difficulties as relationships among the survivors are torn asunder, including litigation. However, the larger problem is the psychological damage that it does to the child, who's left to wonder for the rest of his life whether his parent loved him as much as the parent loved the siblings, because many people believe that



SPOT LIGHT

Happy Hour

Penguin Convention by Charles Addams sold for $30,000 at Swann Auction Galleries' Illustration Art sale in New York City on June 5, 2018. As one can probably derive from this image, Addams, a cartoonist, was best known for his peculiar and darkly humorous illustrations. A few of his recurring characters became known as *The Addams Family*, sparking the successful television spin-off of the same name.

the relative bequest level is the ultimate final barometer of love, even though this isn't true in the vast majority of cases.

Tip: It's been said before, but it bears repeating: Intergenerational estate planning is best.

Note that this is the first installment of a three-part article about the human side of estate planning. In the second installment, I'll introduce three psychological phenomena that shroud every day estate planning. In the third, I'll explore mortality salience (reminders about death), other fears that clients experience in estate planning, concluding with an introduction of two tools that might assist estate planners with their clients: motivational interviewing and appreciative inquiry.

Endnotes

1. Louis H. Hamel, Jr. and Timothy J. Davis, "Transference and Countertransference in the Lawyer-Client Relationship: Psychoanalysis Applied in Estate Planning," 25 *Psychoanalytic Psychology*, at pp. 590-601 (2008).
2. Thomas L. Shaffer, *Death, Property, and Lawyers* (Dunellen Press 1970), at pp. 1-2.
3. In a study conducted by Roy Williams and Vic Preisser, of 3,250 wealthy families, research indicated a mere 30 percent success rate in keeping wealth in a family, which equated to global research finding the same percentage of success. *See* Roy Williams and Vic Preisser, *Preparing Heirs: Five Steps to a Successful Transition of Family Wealth and Values* (Robert D. Reed Publishers 2003).
4. Akin to a Jenny Craig before and after picture/testimonial, most estate planners proudly crow over how much tax their brilliant planning has saved and bill accordingly.
5. This perhaps sidesteps the inherent ethical issues attendant to representing a couple jointly. In the "Path of Most Resistance," p. 54, spouses are each considered separate clients. This should by no means be considered an endorsement of the legal ethics decision to represent a couple as separate clients, because I'm uncertain that this tact may be safely done by a lawyer.
6. *See, e.g.,* Michael P. Nichols, *The Lost Art of Listening* (The Guildford Press 2009).
7. Dr. Albert Mehrabian, author of *Silent Messages*, conducted several studies on nonverbal communication. He found that 7 percent of any message is conveyed through words, 38 percent through certain vocal elements and 55 percent through nonverbal elements (facial expressions, gestures, posture, etc).
8. *See generally* Jo-Ellan Dimitrius and Mark Mazzarella, *Reading People* (Random House 1998).
9. *See generally* Benedict Carey, *How We Learn* (Random House 2014).
10. Shaffer, *supra* note 2, at pp. 115 and 118.
11. John Bradshaw, *Homecoming: Reclaiming and Championing Your Inner Child* (Bantam 1990).
12. Jean Paul Sartre, *Being and Nothingness* (1943): "The totality of my possessions reflects the totality of my being. I am what I have. What is mine is myself."
13. *See, e.g.,* Isabel Briggs Myers and Peter B. Myers, *Gifts Differing: Understanding Personality Types* (Davies-Black 1995) and David Keirsey and Marilyn Bates, *Please Understand Me: Character & Temperament Types* (Prometheus Nemesis Book Company 1984).
14. Howard Zaritsky, "Eight Basic Rules of Practical Practice," set forth in *The Tools & Techniques of Estate Planning* 18th Ed. (National Underwriter 2017), at p. 118.

SPOT LIGHT

Pea(cock) Coat

Christmas Gifts by George Wolfe Plank sold for $22,500 at Swann Auction Galleries' Illustration Art sale in New York City on June 5, 2018. Back before actresses and supermodels graced the covers of *Vogue*, illustrations such as this one (from the December 1913 issue) were featured instead. Plank produced many years of covers in his signature Art Deco style for the publication.

Forbes.com Dec 27, 2020,10:40am EST|336 views

Spirit Of Holiday Giving Can Infuse Your Estate Plan

https://www.forbes.com/sites/martinshenkman/2021/12/27/spirit-of-holiday-giving-can-infuse-your-estate-plan/?sh=53f0cb9424cb

Martin Shenkman Contributor
Retirement
I write about charitable giving and estate planning ideas.

Stewardship and Charity: Charity, caring, giving, and helping others are all part of the holiday spirit. The holidays, perhaps particularly Christmas, are a time when people strive to be generous. Christians are encouraged to give generously and regularly. This is based on the concepts of stewardship. The concept of stewardship stems from a simple premise: "The earth is the Lord's, and everything in it." Psalms 24:1. Thus, we are not the owners of our wealth, but merely the stewards of it for the time we have. One biblical foundation for this is: "*17 You may say to yourself, "My power and the strength of my hands have produced this wealth for me." 18 But remember the Lord your God, for it is he who gives you the ability to produce wealth, and so confirms his covenant, which he swore to your ancestors, as it is today*." Deuteronomy 8:17-18.

Charity, Helping, and Kindness are Universal: Christians have received riches of God's grace, and are to respond with generosity and giving. Christians are called to a life of service, sharing, and stewardship. Christians, like those of other faiths, have an obligation to do good. Jewish concepts of charity or "Tzedaka," and repairing the world, "Tikun Olam," are similar. For Baha'i, charity is pleasing and praiseworthy in the sight of God and is regarded as a prince among goodly deeds. – Baha'u'llah, Tablets of Baha'u'llah, p. 71. For Latter-day Saints, tithing is a natural and integral component of LDS religious beliefs. Islam promotes the virtues of charitable giving. The Quran says, "…when other relations and orphans and the poor are present at the division of the heritage, give them something therefrom and speak to them words of kindness…" (Ch 4:8).) The Buddha emphasized that one should not turn away from suffering but do whatever can be done to relieve it. But charity should be given selflessly, without expectation of reward or praise.

"Helping" certainly equates to charity and kindness. And all of these are universal concepts.

Charity and Kindness Should Extend Beyond Holidays: Regardless of your faith, or no faith, generosity, charity, and helping others are laudable values. These wonderous ideals should not be limited to a donation during a holiday but made a permanent part of your lifestyle and that of your heirs. One way to do just that is to integrate these values into your estate plan. There is a myriad of ways to accomplish this, and options exist regardless of your wealth level. While so many discussions about charitable giving, and particularly as part of an estate plan, focus on securing tax benefits, the discussion following will take a look at some of the human aspects of charitable planning. Charity will be defined broadly in terms of not only facilitating heirs giving money, but encouraging and enabling heirs to volunteer and make a contribution to society, or just "doing good."

Charity is not Only About Money: A wonderful quote about giving is attributed to Mother Teresa who said: "It is Christmas every time you let God love others through you…yes, it is Christmas every time you smile at your brother and offer him your hand." This is particularly apropos to our discussion since giving back and helping others need not only be about money.

It certainly can encompass donations big and small, but also formal volunteerism, a lifestyle of helping in informal ways, even your investment decisions. And all of this can be integrated into your estate plan.

Integrate These Values in Your Estate Plan: Regardless of your faith, or not, you can foster these types of values in your estate plan, thus making them a permanent part of your legacy and encouraging heirs for generations to come to be charitable, volunteer, and more.

Give Trustees Guidance and Make Distributions Discretionary: Giving the trustee broad discretion on when to make distributions, or not, can create the flexibility to make distributions to enable a beneficiary to fund charitable gifts, or to pursue lifestyle decisions that can foster volunteerism and other noble acts. Consider including in the trust instrument precatory non-binding language that encourages the trustee to make distributions that support these actions. For example, consider some of the following languages: "The Settlor encourages beneficiaries to live independently and not have trust assets substitute for personal work efforts. Beneficiaries are encouraged to pursue careers, philanthropy, volunteerism, parenting, and whatever brings them personal fulfillment and benefits those in greater need and society as a whole." The trustee could thus defray beneficiaries living expenses to permit the beneficiary to spend more time volunteering or to use some of the distributions for charitable gifts.

Include Charities in Trusts: The advice of modern trust planning consistently favors shifting substantial wealth into long term or perpetual trusts. While that certainly makes sense from a tax planning and asset protection perspective, as wealthy families shift more wealth into these trusts, if the trusts are not authorized to make distributions to charitable beneficiaries, how will future generations of wealthy benefactors fund charitable giving? A simple solution is to permit the trustee to make distributions to charities. There are many ways to integrate flexibility into charitable giving. Such distributions could require the consent of some or all adult beneficiaries to serve as a safeguard against a trustee abusing the discretion. Another option is to grant someone in a non-fiduciary capacity to direct the trustee to make payments to charities. Alternatively, a person in a non-fiduciary capacity can be granted the right to add charitable beneficiaries to the trust. For even more flexibility, a special charitable distribution trustee could be named, and this could be an entity, e.g. a limited liability company, and have a board of managers that can create a succession of people to perpetuate the grantor's wishes and values to future generations.

Permit or Mandate Philosophically Oriented Investing: Socially responsible investing (SRI) is an investment strategy designed to achieve financial returns but to also achieve specified social goals. The term "philosophical" was used because these goals could be green investment strategies, or perhaps strategies that are consistent with a particular set of religious beliefs, or companies that share certain moral standards. You can and should pursue this manner of investing if it is consistent with your lifestyle choices. But for future generations, it is imperative that for a trust to pursue these goals, that any trust agreement expressly permits these investment approaches, and that you delineate the manner of philosophically appropriate investment strategies.

The beautiful and noble goals of charity, helping the poor, and showing kindness should not be limited to a brief holiday season, but can and should be integrated into your year-round decisions, and how you plan your estate and trusts so that these same positive values can be transmitted to future generations. Remember, estate planning should not only be about the transmission of wealth but the transmission of values as well.

Follow me on Twitter or LinkedIn.

Martin Shenkman

I am an estate planning attorney, author of 42 books, and more than 1,200 articles. I serve on the editorial boards of Trusts & Estates Magazine, CCH (Wolters Kluwer) Professional Advisory Board, CPA Magazine, and the CPA Journal. I’m active in many charitable and community causes and organizations and spend two months/year traveling the country educating professional advisers on planning for clients with chronic illness and raising both awareness and funds for many charities helping people face the challenges of chronic illness. I serve on the board of the American Brain Foundation Board, and its Strategic Planning Committee, and Investment Committee. I hold a BS degree in accounting and economics from Wharton School, an MBA in tax and finance from the University of Michigan, and a law degree from Fordham University School of Law.

UNDERSTANDING GRANTOR TRUSTS

By: Steven Siegel, J.D. LLM (Taxation)

I. Introduction

This article explores grantor trusts and the role they play in Subchapter J. Trusts treated as grantor trusts are "ignored" for income tax purposes with the grantor being viewed as the taxpayer. The need for probate avoidance in many states, the compressed income tax rates on complex trusts, and the desire of many taxpayers to accomplish sophisticated tax planning have led to the use of grantor trusts in many diverse circumstances. Determining whether a trust is or is not a grantor trust presents some challenges. The material which follows explores grantor trust status, its history, how to identify a grantor trust, and the tax consequences surrounding this status.

A. Overview of the Grantor Trust Status

A grantor trust is a trust in which either the grantor or another person possessing sufficient specifically enumerated rights and/or interests in or over the trust is considered to be the "owner" of the trust. The retention or possession of these rights gives the person identified as the grantor dominion and control over the trust property and/or the trust income.

The basic issue in the grantor trust area is who is going to be taxed when the grantor has retained a certain degree of control – the trust, the beneficiary or the grantor. Once a trust is characterized as a grantor trust, the grantor when determining his or her taxable income must include all of the income, deductions and credits available at the trust level.

In order to determine whether a grantor possesses the specifically enumerated rights and interests as described in the governing trust instrument to require classification of the trust as a grantor trust, Code Sections 673 through 677 must be examined, as they define the circumstances under which income of a trust is taxed to the grantor. Reg. 1.671-1(a.) In addition, a person who is not a transferor of property to the trust, but who, as a beneficiary of the trust possesses certain rights, such as a power of withdrawal over the trust income or principal, may be deemed a grantor of the trust and considered to be an owner of the entire trust or a portion of the trust for income tax purposes. Code Section 678.

To the extent that the grantor or another retains certain benefits or control over the trust, the normal rules governing taxation of nongrantor trusts contained in Subparts A – D of Part I of Subchapter J (i.e. primarily the discussion of simple trusts and complex trusts) do not apply. Instead, the trust income is taxed to the grantor or other person with control over the trust under the rules set forth in Subpart E of Subchapter J, Code Sections 671 -678 and the regulations promulgated thereunder.

B. The Historical Background of Grantor Trust Status

When the federal income tax was enacted in 1913, it did not require the grantor of a trust to be taxed on income generated by the trust assets even if the grantor retained control of those assets. Changes made to the Internal Revenue Code in 1924 required the income of a revocable trust to be taxed to the grantor. The next thirty years saw a number of planning techniques attempted by taxpayers and court challenges brought by the government to try to deny attempts by taxpayers to shift income to persons in lower tax brackets through the use of a variety of trust arrangements.

The early cases had a common theme. They all involved efforts by the grantor of a trust to use the trust or its beneficiaries as separate taxpayers in order to take advantage of the entity's lower income tax rates, even in situations where the grantor of the trust retained substantial control over the income and/or principal of the trust. In *Corliss v. Bowers,* for example, 281 U.S. 376 (1930), Mr. Corliss created a revocable trust for the benefit of his wife and children. The trust paid income to his wife, but the IRS assessed income tax against Mr. Corliss. The couple had filed separate income tax returns. Justice Holmes had no problem finding for the government, as he wrote, "[If] a man disposes of a fund in such a way that another is allowed to enjoy the income which it is in the power of the first to appropriate it does not matter whether the permission is given by assent or by failure to express dissent. The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as income, whether he sees fit to enjoy it or not."

These cases addressed issues involving attempted anticipatory assignments of income by high bracket taxpayers to shift the tax consequences of income receipts to the lowest bracket taxpayer. In *Lucas v. Earl*, 281 U.S. 111 (1930) the Supreme Court held that income must be taxed to the one who earns it, a theme seen later in the enactment of the grantor trust rules. In *Helvering v. Horst*, 311 U.S. 112 (1940), the passage of bond interest coupons from donor to donee was held ineffective to give away the right to income since the donor still controlled the bonds from which the interest coupons were derived. These cases led to the "fruit" (the coupons) and the "tree" (the bonds) analogy, with taxation imposed on the taxpayer who retained the "tree." However, where property rights were transferred, and the donor gave away his entire interest, the assignees of the property were recognized as valid donees, and the income was taxed to them. *Blair v. Commissioner*, 300 U.S. 5 (1937). *Blair* was then distinguished in *Harrison v. Schaffner*, 312 U.S. 579 (1941) where a trust beneficiary assigned specified amounts of trust income for a limited term and did not part with a substantial interest in the trust property itself.

The current grantor trust rules arose from this background of Supreme Court cases. Congress enacted these rules as part of the 1954 Internal Revenue Code. At that time, individual taxpayers were faced with extremely progressive and high tax rates. Under the 1939 Code there were twenty separate tax brackets, reaching from 19.2 percent on the first $2,000 to 89 percent on taxable income over $200,000. After 1953, the lowest bracket was due to decline to 17 percent, and the top bracket to 88 percent. The 50 percent tax rate was reached at $20,000. As a planning technique, wealthy taxpayers did whatever they could to shift income to persons, typically family members, in lower income tax brackets. Multiple trusts were created for these persons with the intent that each trust would be recognized as an independent taxpayer to be taxed beginning at the lower end of the progressive rate structure. However, the creators of these trusts tried to maintain as much control over them as they possibly could.

Enter the grantor trust rules. By including Sections 671-678 in the 1954 Internal Revenue Code, Congress forced trust grantors to make a choice—either transfer property into a trust for another person and relinquish control over the income and principal of the trust, and relinquish control over much of the administration of the trust, and shift the income taxation to the trust beneficiary—or retain one or more elements of control or administrative power, and be taxed on the trust income despite having created the trust arrangement for the benefit of another person.

The regulations provide that since the principle underlying Subpart E is generally that income of a trust over which the grantor or another person has retained substantial dominion and control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, it is ordinarily immaterial whether the income involved constitutes income or principal for trust accounting purposes. Accordingly, the references in Subpart E to "income" attributed to the grantor or another person, unless specifically limited, are references to income determined for tax purposes and not to income for trust accounting purposes. If there is an intent refer to trust accounting income, (as described in Reg. 1.643(b)-1) the Subpart E regulations use the phrase "ordinary income." Reg. 1.671-2(b).

II. Grantor Trust Status – The "Ground Rules"

A. General Rules

Code Section 671 broadly describes the tax consequences associated with grantor trust status. It provides generally that a grantor of a trust will be taxed on all of the income, deductions and credits of a trust when such person retains certain powers over or interests in the trust. Code Section 672 provides a series of definitions, and Code Sections 673-678 (all discussed below) detail what powers will—and will not—cause a trust grantor to be subject to the grantor trust rules. A grantor can be taxable on the income or principal of a trust, or both. If the grantor is treated as the owner of only part of the trust, the grantor will be taxed on the income from that part of the trust, and the rest of the income will be taxed according to the regular rules regarding the income taxation of trusts and estates. Reg. 1.671-2(d).

Even if the grantor avoids being taxed on the trust income under the grantor trust rules, it is still possible for the grantor to be taxed under another rule of income taxation, such as the assignment of income doctrine. Code Section 671; Rev. Rul. 58-337, 1958-2 C.B. 13

Under the grantor trust rules a "grantor" includes "any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust." Reg. 1.671-2(e)(1). A gratuitous transfer is any transfer of property (including cash) to a trust for other than fair market value. Reg. 1.671-2(e)(2). A person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under Code Sections 671-677. Reg. 1.671-2(e)(1). A trust can have multiple grantors. For example, assume Susan creates and funds a trust for the benefit of her children, Paula and Julian. Thereafter, Matthew makes a gift to the same trust. Both Susan and Matthew will be considered grantors of this trust. Reg. 1.671-2(e)(6), Ex.1

A grantor trust is a trust under which the grantor (or a person other than the grantor who has been granted the power to vest income or principal in himself) has retained substantial benefits or control of the trust so that the grantor (or other person) is treated as the "owner" of the trust assets for income tax purposes.

Code Section provides that where the grantor or another person is treated as the owner of any portion of a trust, the grantor or such other person must include in his or her own computation of income taxes all items of income, deductions and credits against tax attributable to the portion of the trust of which the grantor or such other person is deemed to be the owner. A person will be treated as a grantor or owner of a trust if "certain circumstances" are present. These "circumstances" refer to the retention of broad powers over and interests in a trust that constitute the basis of the remaining provisions of the grantor trust rules, Regulation Section 1.671-1(a):

• If the grantor has retained a reversionary interest in the trust of a certain amount, within specified time limits. Code Section 673; (*see* Part IV, below);

• If the grantor or a nonadverse party has certain powers over the beneficial interests in the trust. Code Section 674; (*see* Part V, below);

• If certain administrative powers over the trust exist under which the grantor can or does benefit. Code Section 675; (*see* Part VI, below);

• If the grantor or a nonadverse party has a power to revoke the trust or return the trust principal to the grantor. Code Section 676; (*see* Part VII, below);

• If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse. Code Section 677; (*see* Part VIII, below); and

• If a person other than the grantor has the sole power to vest income or principal in himself or herself so as to be treated in the same manner as would be a grantor of the trust. Code Section 678; (*see* Part IX, below).

To re-emphasize the key distinction among trusts, to the extent there are other portions of a trust which are not treated as owned by the grantor or by another person with a grantor-like power over income or principal, these portions of the trust are taxed in accordance with the "normal" rules addressing the taxation of trusts and their beneficiaries as found in Subchapter J, Subparts A through D, Code Sections 641 and following. Code Section 671; Reg. 1.671-2(d).

The operative theory of the grantor trust rules is that the trust is not a separate taxpayer with respect to the various items of income, deductions and credits which the trust itself may generate. Instead, those items must be taxed directly to the grantor or some other person with a grantor-like power over the trust. An item of income, deduction or credit included in computing the taxable income and credits of a grantor or another person under Code Section 671 is treated as if it had been received or paid directly by the grantor or other person, whether or not an individual. Reg. 1.671-2(c). In applying the grantor trust rules, a grantor will be treated as holding any power held by an individual who was the spouse of the grantor at the time the power or interest was created, or an individual who became the spouse of the grantor after the power or interest was created (but, in the latter case, only for periods after the individual became the grantor's spouse). Code Section 672(e).

As a result of these rules, since an item of income, deduction or credit attributed to a grantor must be treated as if it had been received or paid directly by the grantor, the character of that item passes through to the grantor. The existence of the trust does not "filter" or otherwise alter the character of an item. For example, items of tax exempt income pass through the trust to the grantor, Rev. Rul. 60-370, 1960-2 C.B. 203, as do capital gain items. *Scheft. v. Commissioner*, 59 T.C. 428 (1972).

B. Compliance Issues: Tax Reporting Requirements for Grantor Trusts

Must a grantor trust obtain its own taxpayer identification number?

No separate taxpayer identification number is required when a trust is treated as a grantor trust due to the fact that the grantor retains a power to revoke the trust under Code Section 676 and the grantor is a trustee. Instead, such trusts should use the grantor's social security number. Reg. 301.6109-1(a)(2); Reg. 1.671-4(b)(1). Similarly, no separate taxpayer identification number is required for a trust if spouses are the sole grantors, one or both spouses serve as trustees or co-trustees, one or both spouses are the owner(s) of the trust and they file a joint return for the year. Reg. 1.671-4(b)(2). If any of these situations apply, the grantor does not file a separate income tax return for the trust, and reports the trust income on his or her Form 1040.

In all other situations, the trustee should obtain a federal identification number for the trust. If the grantor resigned as trustee, relinquished or lost the right to revoke the trust or died, a taxpayer identification number must be obtained by the trustee, subject to the tax reporting alternatives discussed below.

The Treasury regulations give the trustee three alternative methods to use to satisfy the reporting requirements for a grantor trust. There is the "traditional" reporting method of using Form 1041, or one of two optional Form 1099 reporting methods. Each of these options is described below.

1. The 1041 alternative – Reg. 1.671-4(a)

The trustee applies for a taxpayer identification number for the trust. The trustee files a Form 1041 information return, checks the "Grantor Trust" box, does not complete the separate lines on the return and instead attaches to the return a statement of items of income, deductions and credits for the year in question. The statement (usually a Schedule K-1 or a plain paper schedule) indicates that the reportable items of the trust are being reported by the grantor under the grantor's social security number, and is furnished to the grantor for use in preparing the grantor's income tax return. This method is the one that has traditionally been used by most fiduciaries and tax preparers.

2. The 1099 Grantor-TIN alternative – Reg. 1.671-4(b)(2)(i)(A)

The trustee "need not obtain" a taxpayer identification number until either (1) the first taxable year in which the trust, or any part of the trust is no longer a grantor trust, or (2) the first taxable year of the trust in which the trustee does not report using the grantor's social security number alternative. The trustee provides all payors of reportable income with the name and tax identification number of the grantor and the address of the trustee. The trustee is not required to file either a Form 1041 or Form 1099 with the IRS. Payors of the income to the trust send Form 1099 to the trust showing the reportable income as taxable to the grantor. The trustee delivers all of the Form 1099s it receives to the grantor. The trustee must obtain from the grantor a completed Form W-9. The trustee is required to furnish the grantor with a detailed statement of the applicable items of income, deductions and credits by the due date (including extensions) of the Form 1041. If the grantor is the trustee or a co-trustee of the trust, the statement need not be furnished to the grantor.

3. **The 1099 Trust-TIN alternative – Reg. 1.671-4(b)(2)(i)(B)**

The trustee applies for a tax identification number for the trust. The trustee provides all payors of reportable income with the name, tax identification number and address of the trust. The trustee is not required to file Form 1041, but must file Form 1099. Payors of income send the Form 1099 to the trust showing the reportable income as taxable to the trust. The trustee is required to file Form 1099 with the IRS by the end of February, reporting the total interest, dividends and gains and losses received on a Form 1099-INT or Form 1099-DIV, whichever is applicable. The applicable 1099 shows the trust as the payor and the grantor as both the owner of the trust and as payee. Gross proceeds of sales are reported separately for each sale on a 1099-B. Copies of the Form 1099 are not sent to the grantor. Instead, the trustee sends a statement summarizing this information to the grantor by the due date of the Form 1041. If the grantor is a trustee or co-trustee of the trust, the statement need not be furnished to the grantor. This alternative involves an extra layer of administrative duties i.e. issuance of Form 1099s from the trust to the IRS.

III. <u>Code Section 672 – Grantor Trust Definitions and Rules</u>

The purpose of Code Section 672 is to describe rules and definitions that are used throughout the grantor trust sections of the Internal Revenue Code. Code Sections 672(a) through (c) define the key terms "adverse party," "nonadverse party" and "related or subordinate party". The rules describing when conditions precedent must be satisfied to exercise a grantor power are found in Code Section 672(d). Important rules addressing the role of the grantor's spouse are described in Code Section 672(e). Rules addressing grantor trusts with domestic beneficiaries and foreign grantors are found in Code Section 672(f).

A. <u>Adverse Party</u>

Throughout the grantor trust rules, distinctions are made between an "adverse party" and a "nonadverse party." Often, the presence of an adverse party is significant since the grantor may be protected from a finding of grantor trust treatment (and required income taxation of the grantor) if a particular power of the grantor may only be exercised with the consent of or in conjunction with an adverse party. Conversely, under the various grantor trust provisions of Code Sections 673 through 678, if a nonadverse party holds a power over a trust, even if the grantor does not hold that power, the grantor may be treated as the owner of the trust.

Alternatively, if only the consent of a nonadverse party to a particular action of the grantor is required, the grantor may be treated as the owner of the trust. Clearly, then, the distinction between an adverse party and a nonadverse party is significant.

The term "adverse party" requires a person to have a beneficial interest in the trust. It is defined to mean "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust." A person holding a general power of appointment over a trust is regarded as having a beneficial interest in that trust. Code Section 672(a). A "nonadverse party" is defined broadly as any person who is not an adverse party. Code Section 672(b).

Payors of the income to the trust send Form 1099 to the trust showing the reportable income as taxable to the grantor. Reg. 1.672(a)-1(a) It is possible, however, that a trust beneficiary may be an adverse party only as to a portion of a trust, such as when the beneficiary's right to a share of the income or principal of the trust is limited as to only a part of the trust. Reg. 1.672(a)-1(b). A remainderman may have an interest adverse to the exercise of a power over the trust principal, but not adverse to the exercise of a power over an income interest that precedes her remainder interest. Reg. 1.672(a)-1(d).

The cases recognize a presumption that any adverse party will act in his or her own best interests independent of the wishes or desires of the grantor, regardless of the identity of the adverse party or the relationship between the adverse party and the grantor. Members of the grantor's family and the grantor's close friends can be considered adverse parties when they have substantial interests in a trust that are adverse to the exercise or nonexercise of a power held by the grantor or by an adverse party. *Savage v. Comm'r*, 82 F.2d 92 (3d Cir.1936).

In order for an interest to be considered adverse to the grantor's interest, it must be adverse to the exercise or nonexercise of the power held by the grantor or by a nonadverse party over the income or principal of the trust. It is not enough for just a relationship to be adverse—it is the actual interest in the trust that must be adverse. It is certainly possible for a party with a partial share in a trust to be adverse to the grantor only as to that partial share of the trust. Reg. 1.672(a)-1(b); Reg. 1.672(a)-1(d). A "beneficial interest" requires the adverse interest to be economically adverse. These regulations provide that attribution rules, such as those found in Code Section 318, are not applied to determine if a beneficiary has an interest in a trust.

A trustee is not an adverse party merely because of having an interest as trustee. Being a trustee in and of itself does not convey a beneficial interest in the trust. Having a right to fees and commissions as a fiduciary does not convey a beneficial interest in the trust. Reg. 1.672(a)-1(a); *Reinecke v. Smith*, 289 U.S. 172 (1933); *Duffy v. United States*, 487 F.2d 282 (6th Cir. 1973), c*ert. denied,* 416 U.S. 938 (1974)]. In order for a trustee to be considered as an adverse party, the trustee must also possess a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of one or more of the powers granted to the trustee.

Example: If a grantor creates a trust, but provides that a trustee is given the power to distribute all of the income and principal of the trust to himself or herself, the trustee will be considered to be an adverse party to the grantor. *Estate of Paxton v. Commissioner*, 44 T.C.M. 771 (1982). Alternatively, if the trustee occupies merely an administrative role, and lacks discretion with respect to the beneficial interests in the trust, the trustee will not be considered an adverse party even if the trustee is also a beneficiary of the trust.

As the definition of adverse party indicates, the presence of a beneficial interest for such party is an essential element of the definition. Accordingly, a trust beneficiary will be an adverse party, if the beneficiary holds a general power of appointment over the trust. The interest of the beneficiary may be adverse with respect to the entire trust or be limited to either the income or principal portion of the trust, depending on whether the beneficiary is an income or a remainder beneficiary. If the beneficiary holds its partial interest in a trust (such as an interest in the income only, or in the principal only, or in a contingent remainder interest only) the beneficiary may be an adverse party only with respect to that part of the trust. Reg. 1.672(a)-1(a), 1.672(a)-1(b.) Of course, where a contingent interest is concerned, the remoteness of the contingency should be taken into account in evaluating whether the holder of such an interest is truly an adverse party.

Example 3-2: Alice, Brenda, Carrie and Donna are equal income beneficiaries of a trust. Sam is the grantor of the trust. Sam has the right to revoke the trust with the consent of Alice. In this situation, Sam is treated as the owner of three-fourths of the trust since only Alice is an adverse party with respect to Sam. Accordingly, the items of income, deduction and credit attributable to the three-fourths interest in the trust are included in determining Sam's income tax liability. Reg. 1.672(a)-1(b).

Another important component of the definition of an adverse party is the requirement that the interest of the person holding the beneficial interest must be "substantial." An interest is a substantial interest if its value in relation to the total value of the property subject to the power held by the adverse party is not insignificant. Reg. 1.672(a)-1(a). This limited guidance offered by the regulations has led to a number of cases attempting to define the meaning of a "substantial" beneficial interest. The cases typically depend on an analysis of the particular facts and circumstances. Where the interest of the beneficiary is wholly discretionary in the judgment of the trustee, the beneficiary does not have a substantial beneficial interest. However, where persons were both beneficiaries and also members of a distribution committee, they were found to have adverse interests in the trust. Priv. Ltr. Ruls. 200731019 (May 1, 2007), 200729025 (April 10, 2007), 200247013 (Aug. 14, 2002) and 200148028 (Aug. 27, 2001). Where the interest of the potential adverse party is remote and contingent, the cases indicate that the interest of such party is not "substantial." *Holt v. United States*, 669 F. Supp. 751 (W.D. Va. 1987), *aff'd*, 842 F.2d 1291 (4th Cir. 1988); *Barker v. Comm'r*, 25 T.C. 1230 (1956); *Chase National Bank v. Comm'r*, 225 F.2d 621 (8th Cir. 1955), *cert. denied,* 350 U.S. 965 (1956). However, an interest that is contingent as opposed to immediately vested is not automatically considered an "insignificant" interest. Actuarial calculations may be necessary in order to determine the potential significance of a contingent interest. Reg. 1.672(a)-1(c) Where an apparent adverse interest proves to be a sham (such as when the apparently adverse party has agreed in advance that the adverse interest will not be exercised) such an interest will be disregarded for purposes of the grantor trust rules. *Wesenberg v. Comm'r*, 69 T.C. 1005 (1978).

B. <u>Related or Subordinate Party</u>

There are situations arising under the grantor trust rules where so-called "independent trustees" who are not strictly defined as "adverse parties" are permitted to exercise certain powers without causing the trust grantor to be taxed as the owner of the trust. These powers include such things as distributing to or accumulating income or corpus for a beneficiary under Code Section 674(c); and permitting the trust grantor to borrow the income or principal of the trust under Code Section 675(3). These activities are only permitted, however, for purposes of avoiding the grantor trust rules, where the independent trustees, while not adverse, are not considered related or subordinate parties who are subservient to the wishes of the grantor.

Defined in Code Section 672(c), the phrase "related or subordinate party" means any nonadverse party who is either the grantor's spouse if living with the grantor; the grantor's father, mother, issue, brother or sister (including brothers and sisters of the half-blood) (see Rev. Rul. 58-19, 1958-1 C.B. 251); an employee of the grantor; a corporation or any employee of a corporation in which the stockholdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate employee of a corporation in which the grantor is an executive. All of these persons are presumed to be subservient to the grantor with respect to the exercise or nonexercise of the powers conferred on them unless shown to not be subservient by a preponderance of the evidence. Code Section 672(c); Reg. 1.672(c)-1. Other relatives, such as step-brothers and step-sisters, nieces, nephews, cousins, grandparents, grandchildren and in-laws are not included in the definition of related or subordinate parties.
.

If the grantor possesses a power to remove a trustee and appoint a successor trustee who is not considered "related or subordinate" to the grantor within the meaning of Code Section 672(c), the grantor will not be considered to have retained a power to affect the beneficial enjoyment of the trust property that will result in estate tax inclusion under Code Section 2036 or 2038. It is essential here that the grantor does not retain a power to appoint him or herself as a successor trustee. Rev. Rul. 95-58, 1995-2 C.B. 191; *Estate of Wall v. Commissioner*, 101 T.C. 300 (1993).

In order to rebut the presumption that a related or subordinate party acting as trustee is subservient to the grantor, the person making such a claim has the burden of proving that the trustee was not acting in accordance with the grantor's wishes. S. Rep. No. 1622, 83d Cong. 2d Sess. 87 (1954) A person who is serving as a corporate director is not, absent other evidence, considered an employee of the corporation, even where the holdings of the grantor and the trust are significant in terms of voting control. Rev. Rul. 66-160, 1966-1 C.B. 164. Nor does a partner of the grantor automatically fall within the definition of related or subordinate party. Similarly, persons who serve the grantor in the roles of accountant or attorney are generally independent contractors, not employees, so such persons should not be considered related or subordinate parties, even in situations where such "independent" persons allow the grantor to make virtually all of the decisions involving the trust. *Goodwyn Estate v. Comm'r*, 35 T.C.M. 1026 (1976).

There have been a number of rulings issued addressing the question of whether a family-owned private trust company is a related or subordinate party. The rulings address situations where the families involved have been careful to require a separation between the ownership of interests in property and acting on discretionary distribution committees where those property interests are involved. Where this separation is successfully accomplished, grantor trust characterization is avoided. In the fact patterns of the rulings, various trust grantors did not own any (or a significant amount of) interests in the stock of the private trust company. Only truly independent persons served on the distribution committees. In some situations, the members of the distribution committees had substantial beneficial interests in the income and corpus of the trusts, making them adverse parties. While the rulings are conditioned on the usual "particular facts and circumstances" limitations, they do provide guidance for persons wishing to utilize the private trust company as trustee and avoid attribution of the ownership of the trust to the grantor. Notice 2008-63, 2008-2 C.B. 261; Priv. Ltr. Ruls. 200637025 (June 5, 2006), 200546052 (Aug. 2, 2005), 200546053 (Aug. 2, 2005), 200546054 (Aug. 2, 2005), 200546055 (Aug. 2, 2005).

C. Grantor Power Limited by a Condition Precedent

A person is considered to have a power as the grantor of a trust even if this power is subject to certain limitations. The Code specifies two limitations which are ineffectual to preclude grantor trust status: (i) a condition precedent of the giving of notice or (ii) where an interest takes effect only on the expiration of a certain period of time after the exercise of the power. Code Section 672(d). These provisions are designed to reduce or eliminate any opportunity for a grantor to attempt to manipulate the rules by distinguishing a presently exercisable power from a contingent power.

Example: Kelly is the grantor of a trust for the benefit of her daughter Carol. Kelly retains the power to revoke the trust, but provides that the revocation is effective only after the expiration of three years from the date she exercises the power. Kathy will be treated as the owner of the trust from the date of its inception. Reg. 1.672(d)-1.

D. Powers and Interests Held by the Grantor's Spouse

Any power or interest held by a grantor's spouse is imputed to the grantor by Code Section 672(e). For purposes of the grantor trust rules, the grantor is treated as holding any power or interest held by any individual who was the spouse of the grantor at the time of the creation of such power or interest, or any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to those time periods after such individual became the grantor's spouse. Code Section 672(e)(1).

An individual legally separated from a spouse under a decree of divorce or separate maintenance when the power or interest in the trust is created shall not be considered as married. Code Section 672(e)(2). Accordingly, it is not necessary to have terminated the marriage by a formal divorce decree to prevent the application of the grantor trust rules.

It is important to note here that a person who is married at the time the transfer in trust occurs is deemed to hold the powers and interests in the trust held by his or her spouse, even if the parties later divorce. Priv. Ltr. Rul. 9625021 (March, 20, 1996). Code Section 672(e)'s test for marital status is applied when the trust is created. There is nothing in the law to allow a later retest if there is a change in marital status. If the transfer in trust is made after the dissolution of the marriage, then the parties are considered not married for purposes of the application of the grantor trust rules.

Code Section 672(e) was added to the Internal Revenue Code as part of the 1986 Tax Reform Act. There was concern that a grantor could circumvent the application of the grantor trust rules by using his or her spouse as an agent or as the holder of otherwise impermissible powers or interests in the trust. Code Section 672(e) is effective for transfers in trust made after March 1, 1986. The legislative history of Code Section 672(e) indicates that it is applicable only in cases where the spouse is living with the grantor and able to file a joint income tax return with the grantor for the relevant period.

One of the principal effects of the enactment of the spousal attribution rules is to prevent the grantor's spouse from ever being treated as an adverse party, since any power or interest which might otherwise make the spouse an adverse party is directly imputed to the grantor.

IV. Code Section 673 – Retention of a Reversionary Interest

Code Section 673 provides that the grantor is treated as the owner of any portion of a trust in which the grantor has a reversionary interest in the trust income or principal that has a value, determined at the inception of the trust, *i.e*., the date of transfer of property to the trust, in excess of five percent of the value of the trust property. Code Section 673(a). The same rule applies to a reversionary interest held by the grantor's spouse, since the grantor is treated as the owner of any interest his or her spouse owns. Code Section 672(e). If the grantor is treated as the owner of a portion of the trust, all of the trust's income, attributes, etc. would be treated as belonging to the grantor or to the grantor's spouse, as if no trust had been created. Code Section 673 became effective for transfers in trust made after March 1, 1986.

A. Background on How Code Section 673 Evolved

The "old" Code Section 673 was the Code Section that provided the "roadmap" for the preparation of what was known for many years as a "Clifford Trust," *i.e.,* a trust by which the grantor transferred property for the benefit of a beneficiary for a period of at least ten years, the beneficiary became the taxpayer, after which period the trust property could then revert to the grantor. This was the response of Congress to the decision of the Supreme Court in *Clifford v. Helvering,* 309 U.S. 331 (1940), which held the grantor taxable on the income of an irrevocable trust in which the grantor retained significant control and which was to terminate in the grantor's favor after a five-year term. Congress allowed a transferred interest of ten years to counter the Court's holding. If the ten-year test of delaying the reversion was satisfied, the grantor was *not* taxed on the trust income under the old grantor trust rules, and had effectively shifted the taxation of the trust income to the beneficiary, a person presumably in a lower income tax bracket. The "old" Code Section 673 and the use of the ten-year Clifford Trust was a legislative guideline to a very popular acceptable avoidance of the assignment of income doctrine.

The repeal of "old" Code Section 673 and its replacement by current Code Section 673 was a repudiation of the "permitted" assignment of income exception, and the institution of a rule causing the grantor to be treated as the owner of a trust for income tax purposes if almost any reversionary interest is retained. When the current Code Section 673 was adopted, it became effective only with respect to trusts created after March 1, 1986. The previous version of Code

Section 673 continues to apply to trusts created on and before March 1, 1986. Many, if not all of those trusts (especially if designed as limited to ten year trusts) have now terminated, but if a grantor opted for a delayed reversion term well in excess of the ten year minimum statutory period, it is possible that the "old" version of Code Section 673 is still applicable to these trusts.

Despite possible distinctions between the "old" rules and the new rules of Code Section 673, and the outcome of the actuarial calculations to be performed, if a grantor retains a reversionary interest in the principal of a trust, the grantor will be treated as the owner of the principal of such trust, even if the five percent reversion rule of Code Section 673 is not violated. A grantor will be treated as the owner of any portion of a trust the income of which is or may be held or accumulated for future distribution to the grantor or the grantor's spouse. Where such items as capital gains are allocated to the trust principal under the trust instrument or local law, they are being held or accumulated for future distribution to the grantor as holder of the reversionary interest in the trust principal. Code Section 677(a)(2); Regs. 1.673(a)-1(a), 1.677(a)-1(g), Ex. 2. Accordingly, while Code Section 673 determines whether the retention of a reversionary interest alone makes a trust a grantor trust, Code Section 677(a)(2) is a broader inclusion provision that may require a finding of grantor trust status even if Code Section 673 does not. This suggests a note of caution to be raised for persons drafting trusts designed to minimize a reversionary interest so as to avoid Code Section 673, since Code Section 677 may cast a broader net.

B. <u>The Reversionary Interest</u>

A reversionary interest is an interest retained by the grantor in the trust property that will allow the grantor to recover either the principal of the trust or the income arising therefrom. For example, if a grantor creates a trust, transfers property to the trust for the benefit of a beneficiary, and provides that upon the death of the beneficiary or upon the expiration of a fixed number of years, the transferred property returns to the grantor, the grantor has retained a reversionary interest. If the actuarial value of the reversionary exceeds five percent, a grantor retaining such a reversionary interest will be treated as the owner of the entire trust. Reg. 1.671-3(b)(3); Priv. Ltr. Rul. 9519029 (Feb. 10, 1995).

C. <u>Determining the 5 Percent Interest</u>

The five percent reversionary interest is computed in accordance with standard actuarial principles. It is calculated by considering the maximum amount that the grantor could receive upon the termination of the trust. Code Section 673(c). Code Section 7520 and the regulations thereunder include actuarial tables that apply to reversionary interests that become possessory upon the expiration of a fixed period of time or at the death of a specified person or persons. The actuarial tables are based on the prevailing interest rates at the time the transfer occurs, using the monthly updated applicable federal rate (AFR) issued by the IRS. As a general rule, when interest rates are low, a longer term of the trust will be necessary to fall below the five percent threshold; conversely, in a higher interest rate environment, a shorter term of the trust will yield a reversionary interest that falls below the five percent interest threshold. The actuarial tables are also influenced by mortality rates. While variations will occur depending upon the fluctuations in the applicable interest rate, it presently appears that even using the highest AFRs in the IRS tables, a reversionary interest must be delayed in the range of 28 to 32 years if it is to be worth five percent or less of the value of the transferred property. Reg. 20.2031-7(d)(6) Table B.

When determining the value of the grantor's reversionary interest, it is to be assumed that if there is any discretion exercisable in favor of the grantor, such discretion will be exercised in the grantor's favor to the maximum possible extent. Code Section 673(c).

Example: The grantor creates and funds a trust with a duration of 20 years for the benefit of the grantor's children with distributions to be made in the discretion of the trustee, after which time the trust property will revert to the grantor or the grantor's estate. In determining the value of the grantor's interest under Code Section 673, it must be assumed that no distributions are made to the grantor's children during the 20-year term of the trust. Assume when the trust is created, the prevailing Code Section 7520 rate is 6.2 percent. The value of the reversionary interest would be approximately 30 percent, clearly greater than five percent, and the trust would be a grantor trust. If instead, the term of the trust was 50 years, the value of the reversionary interest would have been approximately 4.9 percent, clearly less than five percent, and the trust would not be a grantor trust. Alternatively, when using a 4 percent interest rate instead of a 6.2 percent rate, the actuarial value of a remainder interest is 5.0754 percent following a term certain of 76 years; the actuarial value of a remainder interest is 4.8801 percent following a term certain of 77 years. Rev. Rul. 76-178, 1976-1 C.B. 273.

As a general rule, the grantor's health is irrelevant in applying the rules of the actuarial tables indicated above. There is, however, an exception for situations when the grantor is terminally ill. A person suffering from an incurable disease or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within one year. Actual physical condition *is* relevant in determining the value of an interest for income tax purposes. Reg. 1.7520-3(b)(3). In such a case, the IRS can ignore the results of the actuarial tables. This exception is modified by an additional rule providing that an individual who survives 18 months or longer after the date of the property transfer is presumed not to have been terminally ill, absent clear and convincing evidence to the contrary. Where this exception applies, the IRS is required to use the actuarial tables to value the interest contingent upon the individual's life expectancy. Reg. 1.7520(b)(3); *Miami Beach First National Bank v. United States,* 443 F.2d 116 (5th Cir. 1971); Priv. Ltr. Rul. 9402011 (October 8, 1993). In these circumstances, it is worthwhile to obtain a physician's certification addressing the probability of death. *Fabric Estate v. Comm'r*, 83 T.C. 932 (1984).

A difficult valuation problem may arise where the trust beneficiary possesses a power of appointment over the trust property. Must (or should) the possibility that the beneficiary could affirmatively exercise that power in favor of the grantor be taken into account in determining the value of a reversionary interest of the grantor? Arguably, yes. Code Section 673(c) provides that the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion by the power holder in favor of the grantor.

D. Exception for Lineal Descendants Who Die Before Age 21

A possible reversionary interest in the grantor or the grantor's spouse that follows the death of a lineal descendant of the grantor or the grantor's spouse prior to such descendant attaining age 21 will not be counted to attribute grantor trust status provided the lineal descendant holds all of the present interests in any portion of the trust, unless and until the reversion actually occurs. Code Section 673(b). This exception enables income earned by a Code Section 2503(c) trust to be taxed to the minor beneficiary of the trust rather than to the grantor. Thus, a traditional Code Section 2503(c) trust should not be a grantor trust merely because the grantor or the grantor's spouse will receive the trust funds back if the income beneficiary dies before attaining 21 – assuming the reversion was not the result of the exercise of a general power of appointment contained in the trust document.

V. Code Section 674 – Power to Control Beneficial Enjoyment

Code Section 674; Regulations 1.674(a)-1 through 1.674(d)-2

Code Section 674 provides a broad general rule making a trust a grantor trust where the grantor has the power to dispose of or affect the beneficial enjoyment of the trust for himself or herself or others, without prevention by an adverse party.

The broad general rule is then subjected to a series of exceptions that modify the general rule by enumerating circumstances allowing the grantor, independent trustees or certain others to exercise specific powers over the trust that do not confer grantor trust status on the grantor.

A. The General Rule of Code Section 674(a)

Code Section 674(a) states a broad general rule which, standing alone, would require almost any trust involving any grantor rights or powers to be treated as a grantor trust during the lifetime of the grantor. It provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the trust, *i.e.,* the principal or income therefrom, is subject to a power of disposition, exercisable by the grantor, the grantor's spouse, or by a nonadverse party, or both, without the approval or consent of any adverse party. The adverse party is an important consideration here. If a co-trustee is also a beneficiary who would be adverse to the exercise of a power by the grantor over the trust, and if the trust requires the trustees to act unanimously, Code Section 674(a) would not be applicable.

The "power of disposition" referred to is broadly viewed to include a fiduciary power, a power of appointment, and any other power to direct the enjoyment of the benefits of the trust, regardless of the capacity in which the power is held, and regardless of whether the power holder can personally benefit. Reg. 1.674(a)-1; Priv. Ltr. Ruls. 200730011 (July 27, 2007) and 9625021 (March 20, 1996). Unless there is an exception to this broad general rule found in Code Sections 674(b) through (d), discussed below, the broad general rule of Code Section 674(a) will prevail.

What constitutes a power to affect the beneficial enjoyment of a trust has been broadly interpreted by case law. It includes, but is not limited to, a power to name the distributees of the trust or to control the enjoyment of the trust income and principal. Several cases and a revenue ruling illustrate this point:

- The grantor's retained right to alter or amend the trust documents was sufficient to treat the grantor as the trust owner under Code Section 674 even though such a right could only be exercised in the capacity of a trustee, with no personal benefit possible for the grantor. *Swanson v. Commissioner*, 518 F.2d 59 (8th Cir. 1975).

- A power to allocate income between or among the beneficiaries of a trust is a power of disposition over beneficial enjoyment regardless of whether the grantor is a permissible recipient. Rev. Rul. 54-41, 1954-1 C.B. 22.

- The grantor's retaining a direct or indirect power to "sprinkle" income and principal of a trust will result in the finding of grantor trust status. *Carson v. Commissioner*, 92 T.C. 1134 (1989).

- The right to use the property of the trust without paying adequate compensation for it is a power of disposition over the beneficial enjoyment of the trust, classifying the trust as a grantor trust. *Wesenberg v. Commissioner*, 69 T.C. 1005 (1978), *nonacq*. 1978-2 C.B. 4.

- The power to determine which beneficiary would be the recipient of income is a power to affect beneficial enjoyment. *Laganas v. Commissioner*, 281 F.2d 731 (1st Cir. 1960).

- When a grantor borrowed money from a bank and loaned the borrowed funds to a trust, with the funds repayable to the grantor on demand, the court found the grantor taxable on the trust's income under Code Section 674(a) because the demand power gave the grantor the power to control the beneficial enjoyment of the trust corpus at any time. *Wysong v. Commissioner*, T.C. Memo 1988-344.

Example: Greg creates a trust for the benefit of Ann and Bart during Bart's life. The remainder will pass to Bart on Ann's death, or to Ann on Bart's death. Greg names his spouse, Wendy, as the trustee and gives her the discretionary power (not limited by an ascertainable standard) to distribute income and principal to Ann or Bart, or to both, during Ann's life. This is a power to alter or control the beneficial enjoyment of both the income and principal of the trust. While Wendy cannot exercise the power in favor of Greg, under Code Section 672(e) all powers held by Greg's wife are deemed to be held by Greg. As a result, he is treated as having the power to alter or control the beneficial enjoyment of the trust and therefore the trust is treated as a grantor trust for income tax purposes even though Greg personally has not retained any direct right to alter or control the beneficial enjoyment of the trust.

Example: Assume the same facts as above except that the trust now provides that Wendy and Ann serve as co-trustees, and that the trustees, acting jointly, have the power to distribute *income* to Ann or Bart, or both, but may not exercise this power in favor of Greg. The trust is not treated as a grantor trust with respect to the trust accounting income because the power to alter or control the beneficial enjoyment of the income interest is exercisable only with the consent of an adverse party (Ann). The trust is treated as a grantor trust with respect to principal because the power to alter or control the beneficial enjoyment of the principal is not subject to the consent or approval of an adverse party.

B. Exceptions to the General Rule of Code Section 674(a)

Notwithstanding the broad general rule of Code Section 674(a), however, there are a number of statutory exceptions to this general rule which specifically refute the general rule and accordingly negate grantor trust treatment. It is essential to address and understand these exceptions which limit the scope of Code Section 674(a) to fully appreciate whether and when a power of disposition over the trust property will, in fact, trigger grantor trust status. There are exceptions from the general rule for certain powers which the grantor or any other person may hold set forth in Code Section 674(b); there are exceptions for powers which a nonadverse, independent trustee may exercise as set forth in Code Section 674(c), and there is an exception for a power which a non-independent, non-adverse trustee (other than the grantor or the grantor's spouse) may exercise as indicated in Code Section 674(d). All of these exceptions allow actions that affect the beneficial enjoyment of the trust without causing the grantor to be treated as the owner of the trust.

Code Section 674(b) sets forth a series of retained powers that will not result in grantor trust status. It contains eight exceptions to the general rule that retention of a power to control who receives income or principal from a trust results in grantor trust status. The exceptions describe the powers that the grantor *or any other person* may hold without causing the grantor to be taxable as the owner of the trust. Discussion of the eight exceptions is provided below.

1. Power to apply income to discharge a legal support obligation.

A grantor is not taxable as the owner of a trust just because a trustee or the grantor, in a fiduciary capacity as trustee or co-trustee, possesses a power to use trust income to discharge a legal support obligation of the grantor. Code Section 674(b)(1); Reg. 1.674(b)-1(b)(1). Instead, the grantor is taxable as the trust's owner only to the extent the trust income is actually used to discharge a support obligation as described in Code Section 677(b). Reg. 1.677(b)-1. State law determines the extent of the grantor's support obligation. Rev. Rul. 56-484, 1956-2 C.B. 23. If the distribution that satisfies the grantor's support obligation is made from principal, the tax consequences of the distribution are governed by the normal rules of Subchapter J, i.e. Code Sections 661 and 662.

If the grantor possesses this power in a nonfiduciary capacity, mere possession of the power alone will cause the grantor to be taxed on the trust income whether or not the trust income is used to support the grantor's dependents. Code Section 674(b)(1) only protects the grantor when serving as a trustee of the trust.

Example: Gary creates a trust and retains the right to require the trustee to distribute income for the health, education, maintenance and support of his children. Gary is not a trustee of the trust. No distributions are made to Gary's children during the year. The trust is a grantor trust. The Code Section 674(b) exception does not apply because the power to distribute income can be exercised by Gary in a nonfiduciary capacity.

_2._ Power affecting beneficial enjoyment only after the occurrence of an event.

A postponed power to affect a trust's beneficial enjoyment creates a grantor trust unless it is postponed for a period which, were it a reversionary interest, would be protected from grantor trust status because the reversionary interest is 5% or less. Unless the power is relinquished, the grantor will be taxed on the income after the occurrence of the event. Code Section 674(b)(2); Reg. 1.674(b)-1(b)(2).

Example: Linda creates a trust at a time when the Code Section 7520 rate is four percent. Income is to be paid to Ryan for 20 years. At the expiration of the 20-year period, Linda will have discretion to determine who receives the income of the trust. Although Linda can only exercise her power after 20 years have elapsed from the date of the trust's creation, Linda still owns all of the trust from its inception under Code Section 674(b)(2), since the value of her reversionary interest in the trust is greater than five percent.

3. Power exercisable only by will.

A testamentary power, *i.e.*, a power exercisable only by a person's will, to control the beneficial enjoyment of a trust qualifies as another exception to the general rule of Code Section 674(a) and does not cause the grantor to be treated as the owner of any portion of a trust. This rule applies even in the case where the grantor or a nonadverse party, or both, hold the power and such power may be exercised without the approval or consent of an adverse party. Code Section 674(b)(3).

Example: Paul creates an irrevocable trust and names his friend, Larry, as the trustee. The trust provides that Larry, by his will, may appoint the principal of the trust among Paul's children in Larry's discretion. Paul will not be taxed as the owner of this trust.

This exception, however, is subject to the following two significant limitations (which constitute exceptions to the exception and thus result in grantor trust status):

(1) Without the approval or consent of an adverse party, if the grantor may accumulate income for testamentary disposition by him or herself, or the grantor's spouse accumulates income for testamentary disposition by the grantor or by a nonadverse party. Reg. 1.674(b)-1(b)(3).

(2) If a trust instrument provides that the income (referring to taxable income here, not fiduciary accounting income) is payable to another person for life, but the grantor (or the grantor's spouse) retains a testamentary power of appointment (general or limited) over the remainder, and under the trust instrument and local law capital gains are added to principal, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion. Reg. 1.674(b)-1(b)(3); Reg. 1.671-3.

Example: Gina creates a trust during her lifetime. The trustee is given discretion to pay the income to Brian or accumulate it during Brian's lifetime. Gina retains the power to appoint the trust principal and any accumulated income by her will. The trust is a grantor trust. The Code

Section 674(b)(3) exception would not apply and Gina's retained power to control the trust property would subject Gina to taxation under the general rule of Code Section 674(a).

4. Power to allocate among charitable beneficiaries.

A grantor is not taxed as a trust's owner if the grantor retains a power to allocate the beneficial enjoyment of the trust principal or income among charitable beneficiaries if such charitable beneficiaries are irrevocably designated and are described in Code Section 170(c) (relating to the definition of charitable contributions). Code Section 674(b)(4); Reg. 1.674(b)-1(b)(4). Thus, a grantor can create a trust with an irrevocable gift of the income or principal to charity and retain a power to designate which charities shall receive distributions from the trust and how much they shall receive. For example, a grantor can retain the right to designate the remainder beneficiaries of a charitable remainder trust and the trust will not be treated as a grantor trust. Grantor trust status will also not be found if the grantor has retained the discretion to "sprinkle" the trust income or principal among the charities described in Code Section 170. If the grantor also retained the power to designate noncharitable beneficiaries of the same funds, this exception to the general rule of Code Section 674(a) would not apply.

Example: Norman creates a trust which provides that the trust income and principal are irrevocably payable solely to religious or educational institutions that are qualified charitable organizations under Code Section 170(c). Norman is not treated as the owner of the trust under Code Section 674(a) even though he retains the power to allocate the income and principal among such organizations in his discretion.

Example: Norman creates a second trust which is designed and qualifies as a charitable lead annuity trust. He names his friend, Lon, as the trustee of this trust. Lon is given full discretion to determine the charitable beneficiaries of this trust. Although Lon is a nonadverse trustee, since the trust beneficiaries are charitable organizations, the power of allocation given to Lon does not cause grantor trust status to be applied to Norman. Priv. Ltr. Ruls. 9604015 (Oct. 27, 1995) and 9604016 (Oct. 27, 1995).

5. Power to distribute principal.

Code Section 674(b)(5) provides two additional exceptions to the general rule of Code Section 674(a) with respect to the power to distribute the principal of a trust. The first provides that grantor trust treatment will not apply to a power to distribute principal either to or for a beneficiary or class of beneficiaries whether or not they are income beneficiaries or remaindermen, provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument. Code Section 674(b)(5)(A). The second applies when principal distributions may be made solely in favor of current income beneficiaries, provided that the principal distributions are required to be charged against those beneficiaries' proportionate shares of the trust principal held in trust for payment of income to that beneficiary, as if the principal constituted a separate trust whether or not it was physically segregated. Code Section 674(b)(5)(B); Reg. 1.674(b)-1(b)(5).

Example: Karen creates a trust providing for the payment of income to her adult children in equal shares for 10 years, after which the principal is to be distributed to her grandchildren in equal shares. Karen reserves the power to pay each child up to one-half of the trust principal during the 10-year period, but if such payments are made, they will proportionately reduce subsequent income and principal payments made to the child receiving the principal. If one-half of the principal is paid to one child, all of the income from the remaining half is thereafter payable to the other child. In this situation, Karen is not treated as the owner of the trust since it qualifies under the Code Section 674(b)(5)(B) exception. Reg.1.674 (b)-1(b)(5)(iii), Ex. 3.

Note that these two exceptions apply to the enumerated powers regardless of by whom they are held, meaning that the grantor or a nonadverse party or both may hold these powers without requiring the approval or consent of an adverse party, and still avoid incurring grantor trust status. If a trust has only one beneficiary, then the grantor, or the grantor's spouse, or a nonadverse party can have complete discretion to distribute principal to a current income beneficiary without having the trust declared a grantor trust. If a trust has but a single beneficiary, principal distributions will necessarily be charged against such beneficiary's share of trust principal.

The "reasonably definite standard" exception will not apply, however, if any person has a right or power to add to the named beneficiaries or to a class of beneficiaries designated to receive the trust income or principal, except in the case where the additions are only to provide for after-born or after-adopted children as beneficiaries. Code Section 674(b)(5). The regulations clarify this point by indicating that in order to trigger grantor trust status; this power (to add beneficiaries) must be held by a non-adverse party. If a non-adverse party has the power to add beneficiaries, other than after-born or after-adopted children, the trust will be treated as owned by the grantor of the trust. Reg. 1.674(d)-(2)(b).

The regulations do offer some guidance as to what is meant by a "reasonably definite standard." The permissible distributees must be either income beneficiaries or remaindermen. The exception does not apply if the power could be exercised in favor of a person who was not otherwise a beneficiary of the trust. Reg.1.674(b)-1(b)(5)(iii), Ex. 1. The entire context and intent of a provision of a trust instrument creating a power must be considered in determining whether the power is limited by a reasonably definite standard. It is not required that the standard consist of the needs and circumstances of the beneficiary. A clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for these purposes. A power to distribute trust principal for the education, support, maintenance, or health of the beneficiary, for the reasonable support and comfort of the beneficiary, or to enable the beneficiary to maintain an accustomed standard of living or to meet an emergency would all be considered limited by a reasonably definite standard. However, a power to distribute principal for the pleasure, desire or happiness of a beneficiary is not limited by a reasonably definite standard. There is no reasonably definite standard if the exercise or nonexercise of the power is left entirely to the conclusive discretion of the trustee. But if the trustee has discretion to act within the defined standard, that may be satisfactory. Reg. 1.674(b)-1(b)(5)(i); *see also United States v. DeBonchamps*, 278 F.2d 127 (9th Cir. 1960), where a standard referring to "needs, maintenance and comfort" was found to be a reasonably definite standard.

Example: Howard creates a trust that provides for the payment of income to his adult children for life with the principal payable to his grandchildren in equal shares. Howard reserves the power to distribute trust principal to pay medical expenses and education expenses that may be incurred by his children or his grandchildren. Howard will not be treated as the owner of this trust by reason of the reserved power to pay medical or educational expenses since it is limited by a reasonably definite standard. Alternatively, if the power reserved by Howard was the power to distribute the trust principal to his children and grandchildren for their general happiness, Howard would be treated as the owner of the trust since the power would not then be limited by a reasonably definite standard. Reg. 1.674(b)-1(b)(5)(iii), Examples 1 and 2.

Example: If, in the above example, Howard also retained the power to add the spouses of his children as additional trust beneficiaries, the trust would then be considered a grantor trust with respect to Howard. If the power was limited to add as additional beneficiaries only after-born or after-adopted children of his children, the trust would not be a grantor trust as to Howard.

6. Power to withhold income temporarily.

.

A grantor will not be treated as the owner of a trust if the grantor or a nonadverse party has the power to distribute income to or for any current income beneficiary or to accumulate the income for such beneficiary so long as the accumulated income must be distributed in one of two ways. For purposes of Code Section 674(b)(6), the term "income" refers to fiduciary accounting income. Reg. 1.674(b)-1(b)(6).

Method #1: The first of the permissible methods of income payment that satisfies this exception involves making payments of the accumulated income to the beneficiary from whom it was withheld, or to the beneficiary's estate or to the beneficiary's appointees if the beneficiary possesses a limited (special) power of appointment. Such a power of appointment must be broad in scope, as it must not exclude from the class of permissible appointees anyone other than the beneficiary, the estate of the beneficiary, the creditors of the beneficiary, and the creditors of the beneficiary's estate (*i.e.,* those potential appointees that would require the beneficiary's power of appointment to be classified as a general power of appointment, rather than as a limited power of appointment under Code Sections 2041 and 2514). The appointees or alternate takers of the beneficiary must not in fact be the grantor, the grantor's estate or the grantor's spouse if eventual grantor trust treatment is to be avoided.

Example: Robert creates a trust and names Joanne as the trustee. The trust provides that Joanne, in her discretion, can pay the trust income to Robert's two adult children, or accumulate the income until each child reaches age 40, at which time all accumulated income must be paid to Robert's children. The trustee's power does not cause Robert, the trust grantor, to be treated as the owner of the trust since the accumulated income must be distributed to the beneficiary when age 40 is attained.

Method #2: On the termination of the trust, or at a designated time when principal is distributed, the accumulated income that was withheld from a beneficiary or class of beneficiaries must be distributed to the current income beneficiaries in shares irrevocably specified in the trust instrument. Code Section 674(b)(6)(B); Reg. 1.674(b)-1(b)(6) The grantor or a nonadverse party is therefore permitted to divert current income from one beneficiary or class of beneficiaries to another, provided that the secondary beneficiaries are current beneficiaries of the trust and the trust clearly defines their shares. However, this exception will not apply if the power is in substance one to shift ordinary income from one beneficiary to another. Reg. 1.674(b)-1(b)(6)(i)(c). Furthermore, the exception under Code Section 674(b)(6) will not apply if anyone has the power to add trust beneficiaries, other than beneficiaries who are after-born or after-adopted children.

Achieving the protection of the Code Section 674(b)(6) exception from grantor trust status can thus be accomplished by providing that accumulated income will be paid to the current income beneficiary from whom it was withheld so long as the beneficiary survives to the distribution date designated by the trust. The trust must, in turn, provide for a distribution date that is reasonably expected to occur within the lifetime of such income beneficiary. The trust must also provide that should the income beneficiary die before the designated distribution date, the share allocated to the income beneficiary must pass to the estate of such beneficiary or to the appointees of the beneficiary or, in the absence of such appointees, to the takers in default of appointment, or to other beneficiaries specified irrevocably in the trust, but not to the grantor or the grantor's estate.

Example: David created a trust providing for payment of income to his adult son, Alex, with David retaining the power to accumulate the income until David's death, at which time all accumulated income is to be paid to Alex. If Alex predeceases David, all accumulations are, at David's death, to be paid to David's son, Matthew, or if he is not living, to alternate beneficiaries (which do not include David's estate) in specified shares. The power retained by David is covered by the exception to Code Section 674(a) since the date of distribution (the date of David's death) should, in the usual case, reasonably be expected to occur during the lifetime of Alex, the beneficiary. It is not necessary for this exception to apply that the accumulations be payable to the estate of Alex or to his appointees should Alex predecease David. Reg. 1.674(b)-1(b)(6)(ii), Ex. 3.

Example: A trust provides that the income shall be payable in equal shares to George's two adult daughters, but George reserves the power to withhold from either daughter any part of that daughter's share of the income and add it to principal of the trust until the younger daughter reaches age 30. When the younger daughter reaches age 30, the trust is to terminate and the principal is to be divided equally between the two daughters or their estates. This is a power to affect beneficial enjoyment. However, the grantor is not taxed on the trust income as the power falls under the exception of Code Section 674(b)(6)(B). Although the exercise of the power may permit the shifting of accumulated income from one beneficiary to the other, since the principal plus all accumulated income is going to be divided equally, the power is excepted by Code Section 674(b)(6)(B) because the shares passing to the two daughters at the termination of the trust are irrevocably set forth in the trust agreement. Thus, the grantor is not treated as owner of the trust.

Example: Assume the facts are the same as in the previous example except that George reserves the power to distribute accumulated income to the beneficiaries in such shares as he chooses. In this situation the power would not come within the exception of Code Section 674(b)(6)(A) (since the income is not payable to his daughter, her estate, her appointees or takers in default set forth in the trust instrument) nor Code Section 674(b)(6)(B) (since the income which may be accumulated pursuant to the power is neither required to be payable only in conjunction of the principal distribution nor is it required to be paid on shares which have been irrevocably specified in the trust instrument).

7. Power to withhold income during disability of a beneficiary.

A grantor will not be treated as the owner of a trust over which the grantor or a nonadverse party, or both, hold a power, exercisable without the approval or consent of an adverse party to distribute or apply income (*i.e.*, fiduciary accounting income) to or for a beneficiary or to accumulate and add the income to the principal of the trust during the legal disability of a current income beneficiary of the trust or while any income beneficiary is under age 21. Code Section 674(b)(7); Reg. 1.674(b)-1(b)(7). This exception is applicable even if the income is not ultimately distributed to the beneficiary from whom it is withheld, or to the estate or appointees of such beneficiary. Instead, the accumulated income can be added to principal and ultimately distributed to others, but not to the grantor or to the grantor's spouse. Reg. 1.674(b)-1(b)(7)(A) and (B) The term "legal disability" is not defined in the Code or in the regulations. *Query:* Would delayed distributions due to substance abuse, gambling addiction or cult membership qualify as a "legal disability"?

A power will not qualify for this exception if any person has a power to add beneficiaries or a class of beneficiaries designated to receive the income or principal of the trust, except where such action is taken to provide for beneficiaries who are after-born and/or after-adopted children.

Example: Bill creates an irrevocable trust for the benefit of his minor daughter, Laura, to pay her the income of the trust for her lifetime, remainder to his grandchildren. If Bill reserves the power to accumulate income and add it to the principal of the trust while Laura is under age 21, he will not be treated as the owner of the trust. Reg. 1.674(b)-1(b)(7). The trust may further provide that upon reaching age 21, the accumulated income may be paid to Laura or accumulated and added to principal so that it may never inure to her benefit but may pass to the grandchildren instead. The power to accumulate income prior to the time Laura is age 21 is a power to affect the beneficial enjoyment of the trust property, but Bill is not taxed on the trust income under Code Section 674(a) because of the exception of Code Section 674(b)(7) which permits Bill to accumulate trust income and withhold it from the income beneficiary and add it to principal as long as this power is exercisable only during the period the income beneficiary is under age 21 or under a legal disability.

8. Power to allocate between principal and income.

A power held by the grantor of a trust or a nonadverse person (or both) to allocate receipts and disbursements between principal and income, even though expressed in broad language, will not cause the grantor to be treated as the owner of the trust under the general rule of Code Section 674(a). Code Section 674(b)(8); Reg. 1.674(b)-1(b)(8). The Service has ruled that the power of a trustee to make a reasonable allocation to income from capital gains realized on assets that had produced limited or no income for the trust qualified for this exception and did not cause grantor trust status where state law authorized inclusion of such a power in the governing instrument. Priv. Ltr. Rul. 9442017 (July 19, 1994). This power can be quite significant where the income and principal beneficiaries are different persons and allocations of income and expense can benefit one interest to the detriment of the other.

Example: Glen creates a trust, income to Amy for life, remainder to Bob. Glen has the power to allocate receipts and disbursements between income and principal. When an item is received by the trust, Glen exercises his power and allocates the receipt to principal meaning that Bob will benefit at the termination of the trust. Glen pays a trustee's fee and charges it to income thereby reducing the income to be received by Amy for that year. The power to allocate receipts and disbursements between income and principal is a power to affect beneficial enjoyment, but Glen will not be taxed on the trust income as the result of possessing this power because Code Section 674(b)(8) says that no matter how broad the power to allocate trust receipts and disbursements between income and principal, the grantor (or nonadverse party) who has this power will not cause the grantor to be taxable on the income of the trust.

C. Exception for Powers Held by an Independent Trustee

The general rule of Code Section 674(a) will not be applied in the case of certain powers that are solely exercisable by "independent trustees." The powers falling within this exception include the power to distribute, apportion or accumulate income to or for a beneficiary or beneficiaries or to, for, or within a class of beneficiaries, or the power to pay out principal ("sprinkle") to or for a beneficiary or beneficiaries or to or for a class of beneficiaries, whether or not they are income beneficiaries. Code Section 674(c)(1) and (2).

This is clearly a powerful exception to the general rule of Code Section 674(a). The grantor will not be taxable on trust income when powers are exercisable solely by one or more trustees, none of which is the grantor, or the grantor's spouse, and no more than half of whom are related to or subordinate to the wishes of the grantor (as these terms are described in Code Section 672(c). Reg. 1.674(c)-1. Note that these are reasonably broad discretionary powers that may be exercised by a nonadverse person without the consent of an adverse person, and still avoid the grantor trust rules.

The exception provided in Code Section 674(c) will not be applicable if any person has a power to add a beneficiary or beneficiaries to a class of beneficiaries designated to receive the income or principal of the trust, with the exception of actions taken to provide for after-born and/or after-adopted children as beneficiaries. In order to trigger grantor trust status, a non-adverse party must hold this power to add beneficiaries. Reg. 1.674(d)-2(b). Where grantor trust status is desired, one power that planners often suggest to be included in a trust instrument is a power held by an independent trustee or a trust protector or other non-adverse party to add beneficiaries, typically charitable beneficiaries. *Madorin v. Commissioner*, 84 T.C. 667 (1985).

If the power to add beneficiaries is the only trust power causing characterization as a grantor trust, the grantor or the designated power holder can release this power to terminate grantor trust status if that should become desirable or necessary.

Example: Paula creates an irrevocable trust for the benefit of her three adult children. Paula names an independent trustee and gives the trustee the power to allocate without any restrictions the amount of income to be paid to each child each year. This power will not cause Paula to be treated as the owner of the trust. Alternatively, if Paula had named herself the trustee, or one of several co-trustees and retained this power, Paula would be treated as the owner of the trust. If Paula refrained from naming herself as a trustee or as a co-trustee, but named as trustees her spouse or her sister, Paula will be taxed as the owner of the trust.

D. Exception Related to Income Allocation Powers Limited by a Standard

The general rule of Code Section 674(a) is subject to another exception in Code Section 674(d). In this case, the general rule will not apply to a power to distribute, apportion or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries if the power is limited by a "reasonably definite external standard" set forth in the trust instrument. This exception is available if the power is solely exercisable without the approval or consent of any other person or by a nonadverse trustee or trustees, none of whom is the grantor or the grantor's spouse living with the grantor. Note that Code Section 674(d) refers to the spouse as one "living with the grantor," while Code Section 674(c) does not add this "living with" requirement. Code Section 674(d); Reg. 1.674(d)-1.

This exception is available whether or not the conditions discussed above of Code Sections 674(b)(6) and 674(b)(7) are satisfied. However, this exception is not available if a non-adverse party has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or principal of the trust except where such action is to provide for after born and/or after-adopted children as beneficiaries. Note that there is no prohibition under Code Section 674(d) for the trustee being related or subordinate to the grantor as there is with respect to the independent trustee exception provided by Code Section 674(c) discussed above.

In determining what constitutes a "reasonably definite external standard," reference is made to the standard set forth in Reg. 1.674(b)-1(b)(5) as discussed above. Note that there may be a distinction between what constitutes a "reasonably definite external standard" and what constitutes an "ascertainable standard." Case law and guidance from the IRS are divided as to whether provisions for an "emergency" constitute an ascertainable standard. *See, e.g. Martin v. United States*, 780 F.2d 1147 (4th Cir. 1986), and *Estate of Sowell v. Commissioner*, 708 F.2d 1564 (10th Cir. 1983)—both finding an "emergency" acceptable as part of an ascertainable standard, and TAMs 8606002 (October 31, 1985) and 8304009 (October 25, 1982)—both finding references to an "emergency" not part of an ascertainable standard. The distinction may turn on the totality of the words used to fashion the desired standard—but the takeaway by the practitioner should be to be careful of the wording of a standard especially when the grantor is serving as a trustee in order to avoid an unwanted inclusion for estate tax purposes.

E. The Power to Remove a Trustee

A grantor must be careful if he or she wishes to retain an unrestricted power to remove or replace a trustee. A power in the grantor to remove, substitute or add trustees may prevent the trust from qualifying for the exceptions provided by Code Sections 674(c) and (d). If the grantor possesses an unrestricted power to remove an independent trustee and substitute any person including the grantor or the grantor's spouse as trustee, the trust will not qualify under these exceptions.

Conversely, if the power of the grantor to remove, substitute or add a trustee is limited so that the exercise of this power could not alter the trust in any manner that would disqualify it under Code Sections 674(c) or (d), the existence of the power itself will not disqualify the trust from the exceptions to grantor trust status provided under these sections. Reg. 1.674(d)-2(a).

Example: Ben creates a trust and names Dan, an unrelated party, as the sole trustee. Ben retains the power to remove Dan as the trustee and substitute any other person, including himself as the successor trustee. In this situation, Ben's power is too broad to permit the exceptions of Code Sections 674(c) and (d) to apply. *See Corning v. Commissioner*, 24 T.C. 907 (1955), *aff'd*, 239 F.2d 646 (6th Cir. 1956), where the grantor's power to substitute trustees without cause required that the powers of the trustee be attributed to the grantor. Alternatively, suppose Ben retained the power to remove Dan as the trustee and substitute another independent trustee in Dan's place, which trustee could not be Ben or Ben's spouse. In this latter case, such a power should not affect the availability of any of the exceptions allowed under Code Section 674. Similarly, if Ben named First Bank as the trustee and he retained the power to replace First Bank with another corporate trustee, such a retained power would not affect the availability of any of the exceptions allowed under Code Section 674.

F. The Power to Add Beneficiaries

The various exceptions to the general rule of Code Section 674(a) described in Code Sections 674(b)(5)(6) and (7) and Code Sections 674(c) and (d), are not available if any person, whether independent or adverse, has a power to add one or more beneficiaries or to a class of beneficiaries to receive the trust income or principal, except where the action is to provide for after-born and/or after-adopted children. However, this limitation does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed to his or her own interest in the trust. In such a case, the beneficiary holding such a power would then become an adverse party as to the exercise or non-exercise of that power. Reg. 1.674(d)-2(b).

Example: Carol is a beneficiary of a trust created by her sister, Anne. The trust is not a spendthrift trust. Carol has the right to assign her interest in the trust to her children. This right of assignment is not considered to be a power to add to the group of beneficiaries (since Carol would be an adverse party as to the exercise or non-exercise of her power), so it does not threaten to trigger grantor trust status for Anne, the grantor. Similarly, if Carol had a testamentary power of appointment to name one or more additional beneficiaries by her will, that would not be considered a power to add to the group of beneficiaries and would not trigger grantor trust status for the grantor. Reg. 1.674(d)-2(b).

Sometimes grantors seek grantor trust status for the trusts they establish. One way to accomplish this would be to give a nonadverse party the power to add charitable beneficiaries as additional beneficiaries of the trust; another way would be to give a third party who is not a trustee and not a beneficiary (such as a trust protector) a presently exercisable power of appointment over the trust.

VI. Code Section 675 - Administrative Powers Retained by the Grantor

Code Section 675 provides that the retention of certain administrative powers by the grantor, the grantor's spouse or a nonadverse party will cause the grantor to be taxed on the trust income. Code Section 675 addresses situations where administrative controls are exercisable primarily for the benefit of the grantor rather than for the trust beneficiaries. The administrative power must affect all of the income and principal interests. Reg. 1.675-1(a). If the grantor or the spouse of the grantor possesses a power to amend the trust, even if that power would not be enough to cause Code Section 676 exposure (dealing with the power to revoke the trust, discussed in Section VII, below) the trust will be treated as if such an amendment had already been made and will cause a trust be treated as a grantor trust if the power of amendment would allow the grantor or the grantor's spouse to establish or exercise any of the administrative powers described in Code Section 675. Reg. 1.675-1(a).

There are four categories of administrative powers and controls that make a grantor the owner of the portion of the trust to which they apply: A) Power to Deal for Less than Adequate and Full Consideration; (B) Power to Borrow without Adequate Interest or Security; (C) Borrowing of Trust Funds; and (D) General Powers of Administration. Each of these four categories are discussed below.

A. The Power to Deal for Less than Adequate and Full Consideration

The grantor will be treated as the owner of a trust, or portion of a trust, if the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, holds a power that enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the trust principal or the income therefrom for less than an adequate consideration in money or money's worth. Code Section 675(1).

If a power exercisable by a trustee is described in broad terms, that does not necessarily mean that the trustee has the authority to purchase, exchange or otherwise deal with or dispose of the trust property for less than adequate and full consideration. However, examination of the actual administration of the trust may lead to the conclusion that such authority exists. Reg. 1.675-1(c).

Nothing in Code Section 675(1) prohibits the grantor or a nonadverse party from dealing with trust assets for adequate consideration in money or money's worth. Transactions such as entering into a purchase of the trust assets for their fair market value or entering into a lease at a fair rental price should not trigger Code Section 675(1). However, before concluding that the presence of fair and adequate consideration automatically removes the possibility of grantor trust status, one must consider the other administrative provisions of Code Section 675 discussed below, in particular the power to reacquire trust assets by substituting assets of equal value set forth in Code Section 675(4)(C). For example, a sale and leaseback to a trust by the grantor has been held to result in grantor trust status. Rev. Rul. 54-9, 1954-1 C.B. 20.

B. The Power to Borrow without Adequate Interest or Security

The grantor (or the grantor's spouse, as the result of Code Section 672(e)) will be treated as the owner of any portion of a trust where the grantor or a nonadverse party may exercise a power which enables the grantor to borrow the principal or income of the trust directly or indirectly, without providing both adequate interest and adequate security. Code Section 675(2). If the grantor's power extends to borrowing the principal or income of the trust, the grantor trust status will extend over the entire trust. The power held by a nonadverse trustee to lend to the grantor a portion of the trust property that was not limited to any particular portion of the trust caused the grantor to be treated as the owner of the entire trust for income tax purposes. Priv. Ltr. Rul. 200840025 (June 13, 2008).

There is an exception to the foregoing rule. It provides that when a trustee, (other than the grantor or the grantor's spouse acting alone as trustee), is authorized by the trust document under a general lending power to make loans to any person without regard to interest or security. Code Section 675(2). Should the grantor possess a general lending power, acting alone as trustee, under which the grantor has the power to determine interest rates and the adequacy of security, such power does not in itself indicate that the grantor in fact has the power to borrow the principal or income of the trust without adequate interest or adequate security. Reg. 1.675-1(b)(2). If the trust funds are actually loaned to the grantor without adequate interest or adequate security, this may result in a finding of grantor trust status. Reg. 1.675-1(c).

Note that the mere existence of the power to borrow without adequate interest or adequate security held by the grantor or the grantor's spouse will cause grantor trust status to be recognized, regardless of whether the power is actually exercised. Priv. Ltr. Ruls. 200840025 (October 3, 2008), 199942017 (October 22, 1999), 9645013 (November 8, 1996) and 9525032 (June 23, 1995).

Allowing the grantor to have the power to borrow funds from the trust without providing *either* adequate interest or adequate security is sufficient to cause the trust to be treated as a grantor trust. If a trustee is given the power to make an unsecured loan to the grantor, the trust will be treated as a grantor trust even if the loan provides for adequate interest. Priv. Ltr. Ruls. 199942017 (July 22, 1999), 9645013 (Aug. 9, 1996) and 9525032 (March 22, 1995). A sale of the assets of the trust to the grantor on credit (in exchange for the promissory note of the grantor) is considered an indirect borrowing by the grantor.

C. Borrowing of the Trust Funds

Code Section 675(3) provides a broad general rule that the grantor will be treated as the owner of any portion of a trust where the grantor has borrowed, directly or indirectly, principal or income of the trust and has not completely repaid the loan, including any interest, before the beginning of the next taxable year. That being the case, if a loan to the grantor has been outstanding at any time during the year, grantor trust status will apply for the entire year, even if the loan is repaid, with interest, before the end of the taxable year. Rev. Rul. 86-82, 1986-1 C.B. 253; *Mau v. United States*, 355 F. Supp. 909 (D. HI. 1973). Arguably, then, a loan made on December 31 of Year 1 and repaid on January 2 of Year 2 would cause a trust to be treated as a grantor trust for all of Year 1 and Year 2.

Code Section 675(3) provides an important exception to the foregoing rule. It states that grantor trust status will not result if the loan to the grantor or the grantor's spouse provides (i) adequate interest and adequate security and (ii) the loan is made by a trustee other than the grantor, the grantor's spouse or a related or subordinate party. Reg. 1.675-1(b)(3). Loans made to a grantor that provided for adequate interest and adequate security by trustees who were the grantor's attorneys and not considered related or subordinate parties were found to qualify under this exception and to not trigger grantor trust status. *Zand v. Commissioner*, 71 T.C.M. 1758 (1996), *aff'd on other grounds*, 143 F.3d 1393 (11th Cir. 1998).

The rule of Code Section 675(3) also extends to situations where it can be shown that the grantor or the grantor's spouse has "indirectly" borrowed from the trust, causing the trust to be treated as a grantor trust. A series of cases described below has addressed the indirect borrowing issue.

There has been controversy with the IRS as to what portion of the trust the grantor will be deemed to own. The IRS position is that a grantor who borrows any amount from a trust should be treated as owner of the entire trust. The Tax Court agreed with the IRS position in *Benson v. Commissioner*, 76 T.C. 1040 (1981) holding that a grantor who had borrowed all of the income of a trust should be treated as the owner of the entire trust. In another case, a grantor was treated as the owner of a trust where the trust purchased the grantor's notes. The Tax Court found that the grantor had indirectly borrowed the trust's assets in this situation, but only taxed the grantor on the income derived from the trust on the amount borrowed. *Holdeen Estate v. Commissioner*, 34 T.C.M. 129 (1975). Loans made from a trust to a general partnership of which the grantor was a partner were treated as if made to the grantor directly, causing grantor trust status. However, a loan from the trust to a corporation controlled by the same grantor was held to not create a grantor trust status. A distinction was made based on the grantor's personal liability for the obligations of the partnership and the basis increase in the partnership interest that resulted from the partnership borrowings. *Bennett v. Commissioner*, 79 T.C. 470 (1982); *Buehner v. Commissioner,* 65 T.C. 723 (1976). In *Bennett*, the Tax Court held that the grantor who borrowed principal should be should be taxed on the "portion of the current year's trust income which the total unpaid loans at the beginning of the taxable year bear to the total trust income of prior years plus the trust income for the taxable year at issue."

When the grantor borrows from a grantor trust, the grantor cannot claim an interest deduction for interest paid to the trust. The IRS position is that a grantor trust and its grantor are a single entity for purposes of income taxation, and that the grantor and the trust cannot enter into a bona fide sale or indebtedness situation for income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184; *contra*, *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984), which case the IRS specifically noted it will not follow when it issued Rev. Rul. 85-13. Even if a loan would otherwise satisfy the requirements for allowing the deduction of investment interest or business interest, and even if there was adequate interest and adequate security provided, and even if the trustee is not a related or subordinate party within the meaning of Code Section 672(c), the interest paid by the grantor to the trust is not deductible. There is no creation of a genuine debtor-creditor relationship in such a situation. *Wilken v. Commissioner*, 53 T.C.M. 965 (1987); Rev. Rul. 86-106, 1986-2 C.B. 28; TAM 8709001 (Nov. 10, 1986).

D. General Powers of Administration

There are several general powers of administration over a trust which, if exercisable by any person in a nonfiduciary capacity (i.e. other than as a trustee) without the approval or consent of any person in a fiduciary capacity, will cause the holder of those powers to be treated as the grantor of the trust. Code Section 675(4). If a power is exercisable by a trustee, it is presumed to be exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. If the power is not exercisable by a trustee, the determination of whether the power is exercisable in a fiduciary capacity depends on the terms of the trust and all of the facts and circumstances surrounding its creation and administration. Reg. 1.675-1(b)(4). The IRS will typically not rule on whether a power is exercisable in a fiduciary or in a nonfiduciary capacity. The IRS has called this a question of fact that may only be resolved after the tax returns have been filed. Priv. Ltr. Ruls. 200731019 (August 3, 2007), 199942017 (October 22, 1999), and 9645013 (June 8, 1996).

Code Section 675(4) lists three powers of administration that must be taken into account here, namely:

1. A power to vote or direct the voting of the trust's stock or other securities of a corporation in which the holdings of the trust and the grantor are significant from the viewpoint of voting control, without the approval of any person in a fiduciary capacity. Code Section 675(4)(A); Reg. 1.675-1(b)(4)(i). No guidance is offered as to the meaning of "significant."

2. A power, exercisable in a nonfiduciary capacity, to control the trust's investments in stock or securities of a corporation in which the holdings of the trust and the grantor are significant from the viewpoint of voting control, either by directing or vetoing the trust's investments or reinvestments; Code Section 675(4)(B); Reg. 1.675-1(b)(4)(ii). Again, no guidance is offered as to the meaning of "significant."

3. A power, exercisable in a nonfiduciary capacity, to reacquire the assets of the trust by substituting other property of an equivalent value. Code Section 675(4)(C); Reg.1.675-1(b)(4)(iii). Note that the power to reacquire trust assets need not be expressly stated in the trust instrument in order to create a grantor trust. A grantor who retained a lien on property transferred to a trust was held to have a power to reacquire the trust assets by substituting assets of equal value. *Barber v. United States*, 251 F.2d 436 (5th Cir. 1948).

Possession of one or more of these powers creates a grantor trust regardless of the identity of the person (adverse, nonadverse, independent, etc.) holding the administrative power in a nonfiduciary capacity.

Planning Opportunity Using the Power of Substitution

It is possible for a person to hold a nonfiduciary power in a trust to substitute assets of equivalent value and be treated as the grantor of that trust for income tax purposes, without having the trust property included in his or her estate. This power has been a “favorite” of planners seeking to leave the grantor taxable on the income of a trust while alive, but keep the trust property from being taxed in the grantor’s estate. It is one of the powers most often used in creating an “intentionally defective grantor trust.”

Several important requirements should be observed if a trust is to be designed to achieve this result. The power to substitute property should not be held by the trustee. Since achieving the desired grantor trust status requires that the power of substitution be held in a nonfiduciary capacity, allowing the trustee to exercise this power would fail to meet this requirement. The trustee should be viewed as independent and should be required to certify that the “property of equivalent value” standard has been met.

The power of substitution should not be held by an adverse party, such as a trust beneficiary. The regulations refer to powers of administration held in a nonfiduciary capacity “by any nonadverse party” Reg. 1.675-1(b)(4). Accordingly, giving the power of substitution to anyone who could be deemed an adverse party or requiring approval of an adverse party would create a problem for the grantor who desired to be treated as the grantor of the trust.

The estate inclusion issue was addressed in Rev. Rul. 2008-22. 2008-1 C.B. 796 (April 17, 2008). The ruling concluded that a grantor’s retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor’s gross estate under Code Section 2036 or Code Section 2038, provided an independent trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor’s compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. The key factor seems to be the affirmation by the independent trustee of the equivalency of value with respect to the substitution of properties. This is the essence of the trustee’s fiduciary obligation in these situations.

Modification of an irrevocable trust (through decanting or court order, for example) in accordance with state law provisions giving the donor a power of substitution in a non-fiduciary capacity without requiring the approval of anyone in a fiduciary capacity is the creation or affirmation of a grantor trust. Priv. Ltr. Ruls. 200848006 (November 27, 2008), 200848015, 200848016, 200848017 (November 28, 2008).

With the high federal transfer tax exemption enacted by the 2017 Tax Cuts and Jobs Act, planning for most taxpayers shifts to income tax planning. Securing stepped–up basis adjustments is a centerpiece for income tax planning. An advantage of the substitution power is the flexibility of exchanging low basis assets held by a grantor trust with higher basis assets owned by the grantor individually, without requiring recognition of gain or income. Rev. Rul. 85-13, 1985-1 C.B. 184. If the grantor holds the low basis assets returned to the grantor in the exchange until death, they will receive a fair market value basis at that time. Code Section 1014.

VII. Code Section 676 - The Power to Revoke a Trust

Code Section 676 provides the general rule that the grantor is treated as the owner of any portion of a trust as to which the grantor, the grantor's spouse or a nonadverse party (or both) can exercise the power to revoke or revest title to any portion of the trust in the grantor. (The power need not be actually exercised for these rules to apply). A typical living (inter vivos) trust over which the grantor retains the right to revoke the trust is a grantor trust. If a trustee has discretion to distribute trust principal to the grantor, and the trustee is a nonadverse party, Code Section 676 will apply. Rev. Rul. 57-8, 1957-1 C.B. 204.

A grantor will be treated as the owner of a trust which could be revoked only upon receiving the unanimous consent of the grantor and a trustee which was not adverse to the grantor. Rev. Rul. 75-257, 1975-2 C.B. 251. Conversely, if the power to revoke retained by the grantor is made conditional on receiving the consent of an adverse party, it will not be viewed as a power to revest the trust property in the grantor, and Code Section 676 will not apply. *See* Priv. Ltr. Ruls. 200731019 (May 1, 2007) and 200729025 (April 10, 2007) involving a "sprinkling" trust where the grantor was a permitted beneficiary based on the exercise of discretion by several other persons, who were also permitted beneficiaries.

The power to revest is broadly defined to include not only the power to revoke the trust, but also the power to terminate, alter or amend the trust, or to appoint the trust property, so long as the trust property will return to the grantor. Reg. 1.676(a)-1. The grantor's (or the grantor's spouse's) power to purchase trust assets for less than full and adequate consideration will trigger Code Section 676. The key point here is being able to exercise these powers to enable the trust property to return to the grantor. The transfer of stock to a trust and the retained power to direct the sale of that stock, terminate the trust and receive the trust property was held to be the power to revoke the trust. Rev. Rul. 71-548, 1971-2 C.B 250. The power to direct the trust investments was held not to constitute a power of revocation. *Maloy v. Commissioner*, 45 B.T.A. 1104 (1941)

Two grantors may not, however, succeed in getting around the nonadverse party rules by deliberately combining their property into a single trust, and conditioning their rights of revocation on the approval of the other person, which, if granted, would allow the trust property to be shared equally. In such a case, each grantor was found to be the owner of one-half of the trust property. *de Amodio v. Commissioner*, 299 F. 2d 623 (3d Cir. 1962).

Example: Christine creates a trust, funds it with her personal assets, names herself the beneficiary and trustee and retains the right to revoke the trust. During her lifetime, she is the income and principal beneficiary of the trust. This trust is an example of a "typical" living trust used by many persons in many states. It is a grantor trust for a number of reasons, not the least of which is the retained right to revoke the trust per Code Section 676. All of the trust income will be taxed to Christine. At her death, the right to revoke the trust will result in the inclusion of the trust assets in her estate. Code Section 2038.

In order to create a power to revoke in its simplest, most obvious form, the grantor states in the trust instrument that the grantor has reserved the power to revoke the trust. It is possible, however, that a trust may be deemed to be revocable by presumptions of state law where, for example, a state law provides that any trust not made explicitly irrevocable is deemed to be revocable. Such a situation could result in an unanticipated (and possibly unwanted) grantor trust characterization. *Gaylord v. Commissioner*, 153 F.2d 408 (9th Cir. 1946); *United States v. Pierce*, 137 F. 2d 428 (8th Cir. 1943) It may be possible to retroactively amend or reform a trust (or possibly to decant it) to avoid the state law presumption and obtain the desired characterization. *Flitcroft v. Commissioner*, 328 F. 2d 449 (9th Cir. 1964); *Heintz v. Commissioner,* T.C. Memo 1980-524.

A Totten trust is an arrangement whereby a person deposits funds in his or her own name in a savings or similar account for a chosen beneficiary and the depositor then names himself or herself as the designated "trustee" for such beneficiary. These accounts are sometimes designated as "ITF" trusts (in trust for) or P.O.D. (payable on death) accounts. The depositor/trustee generally has the unlimited right to withdraw the assets from the account while living and revest the property in himself or herself. Accordingly, the depositor/trustee is treated as the establishing the equivalent of a revocable trust and as such is taxable on all of the trust income. Rev. Rul. 62-148, 1962-2 C.B. 153. Whether or not the depositor/trustee actually withdrew funds from the trust is irrelevant. The right to withdraw is the determinative factor. *Oppenheimer v. Commissioner,* 52 T.C.M. 980 (1986).

Note that to be considered an "adverse interest," the interest of the adverse party must be a substantial beneficial interest that would be adversely affected by the distribution of trust income or principal. If the allegedly adverse interest is remote and/or contingent, whether it is truly "adverse" or not may be challenged by the IRS. In such cases, the question becomes an issue that turns on the facts and circumstances of the particular trust. *Holt v. United States*, 669 F.Supp. 751 (DC Va. 1987) (where the likelihood of the trustees ever becoming beneficiaries was after a chain of deaths of younger beneficiaries and highly unlikely, so no adverse interest was found); *Moore v. Commissioner*, 3 T.C. 1205 (1944), *acq*. 1944 C.B. 20 (where trust property could be recovered only with the approval of all corporate directors and shareholders, which was unlikely, so an adverse interest was found).

In the typical living trust, the grantor retains the right to revoke the entire trust, so, where that is the case, it follows that the grantor is treated as the owner of the entire trust. If, however, the grantor's power of revocation extends over only a portion of the trust, only that portion will be considered as owned by the grantor under Code Section 676. How the power to retain an interest in the trust is described in the trust document may be a key determining factor as to whether the grantor has retained a full or partial right to revest title in himself or herself.

If the grantor's spouse, but not the grantor, possesses the power to revoke the trust and revest title in the grantor, grantor trust status will apply.

Example: Craig creates a trust for the benefit of his children and retains the right to revoke the trust and revest the property in himself. The trust is a grantor trust as to Craig. Assume further that Craig is married to Ariel. If Craig relinquishes the power to revoke the trust and gives the exclusive power of revocation to Ariel, so long as title to the trust property can be revested in Craig if there is a revocation grantor trust status will apply.

The Code provides an exception to grantor trust status if the right to revoke is not immediate and commences after an event or period of time. Code Section 676(b). However, this exception only applies in those situations when, had the power been a reversionary interest, the grantor would not have been taxed as the owner of the trust under Code Section 673. Recall that Code Section 673 causes the grantor to be taxed as owner of a trust where the grantor possesses a more than five percent reversionary interest in the trust property. *See* Section IV, above. Once the deferral period ends, the grantor will be treated as the owner of the entire trust by virtue of the power to revoke, unless the grantor relinquishes that power.

Example: Bob creates a trust for the lifetime benefit of his son, remainder to his son's children, and provides that in the event his son remarries, Bob has the right to revoke the trust. Assuming that Bob's interest in this trust is valued at less than five percent, this trust would not be treated as a grantor trust. If Bob's son does remarry, then Bob's right to revoke would cause him to be treated as the owner of the trust, unless he relinquishes the power of revocation. Code Section 676(b); Reg. 1.676(b)-1.

Caution: the "Family Estate Trust" is not a viable planning tool. A number of taxpayers attempted to circumvent the grantor trust rules by using a technique that came to be known as the "family estate trust." An individual would transfer all of his or her assets, including a personal residence, rental property, investment holdings, business assets, personal assets, etc. to a trust, and assign his or her lifetime services to that trust. The trust was then divided into beneficial interest units, and the units distributed as gifts to the individual's family members. The trust collected the compensation earned by the transferor as either an employee or a self-employed person. The transferor typically received a fee for services performed for the trust, as well as basic living expenses from the trust, and retained the right to either revoke or terminate the trust. The taxpayer's intent was to have the income received by the beneficial interest units taxed to the individual unit holders, rather than to the trust grantor.

This position was never accepted by the IRS. The IRS rejected the concept that the grantor/transferor of a family estate trust had shifted the responsibility for income tax liability to other family members. The payments of salary and other compensation made to the trust for the services performed by the transferor were considered assignments of income, and taxed directly to the transferor as retained interests in the trust income of a grantor under Code Section 677. *See* Section VIII of this Chapter, below. The remaining income of the trust was taxed to the grantor/transferor under the revocable trust rules of Code Section 676. Rev. Rul. 75-257, 1975-2 C.B. 251. Among the many cases sustaining the government's position are the following: *Markosian v. Commissioner*, 73 T.C. 1235 (1980); *Vercio v. Commissioner*, 73 T.C. 1246

(1980); *Holman v. United States*, 728 F.2d 462 (10th Cir. 1984); *Vnuk v. Commissioner*, 621 F.2d 1318 (8th Cir. 1980).

VIII. Code Section 677: Income for the Benefit of the Grantor

A. General Rules of Code Section 677

Code Section 677(a) treats the grantor as the owner of any portion (or all) of a trust as to which the grantor or any nonadverse party (or both) may use the trust income for the benefit of the grantor or (for trusts created after October 9, 1969) the grantor's spouse without requiring the approval or consent of an adverse party. "Income" here is defined to mean income in a tax sense, rather than fiduciary accounting income. As described below, Code Section 677 covers a wide variety of situations where the grantor is benefitted by the trust income.

Just the possibility of payments to or accumulations for the grantor or the grantor's spouse is enough to trigger the application of Code Section 677(a), assuming no approval or consent of an adverse party is involved. It is not necessary to demonstrate that actual distributions were received from the trust. Code Section 677(a) applies both to actual distributions and constructive distributions from a trust. Constructive distributions to the grantor or to the grantor's spouse include distributions on behalf of the grantor or the grantor's spouse or payments made to others at the direction of the grantor or the grantor's spouse. Reg. 1.677(a)-1(c).

Example: Joe creates a trust for the benefit of himself and his wife, Betty. First Bank is named the trustee. The trustee is authorized to accumulate the income and only pay it to Joe or Betty in the event of an emergency. Code Section 677 applies to this trust treating Joe as the grantor whether or not any distributions are made.

As a general rule, the grantor is treated as the owner of a portion of a trust the income of which is, or in the discretion of the grantor or a nonadverse party, or both, may be applied to discharge a legal obligation of the grantor or the grantor's spouse. Reg. 1.677(a)-1(d). The "legal obligations" of a person are generally determined by the rules of local law. Obligations include not only support, but also debts, tax obligations, and general claims of creditors.

As the result of the 2017 Tax Cuts and Jobs Act, trusts created by persons after December 31, 2018 to satisfy alimony obligations will be taxed to the grantor. The 2017 Act prospectively repealed the deduction for alimony payments by the payor of Code Section 71, and also prospectively repealed Code Section 682 which had provided that the recipient of payments from a trust created to address alimony obligations was taxed on such payments, and not the grantor. If persons divorce before the end of 2018 and use a Section 682 alimony trust, the rules of Section 682 will continue to apply to that trust going forward. IRS Notice 2018-37.

B. Specific Situations Described in Code Section 677(a)

.

Several specific situations are enumerated in Code Section 677(a) which will cause grantor trust status to be found when the trust income can be used in one or more of the situations listed below. These include having the trust income:

• Distributed to the grantor or to the grantor's spouse. Code Section 677(a)(1);
• Held or accumulated for future distribution to the grantor or the grantor's spouse. Code Section 677(a)(2); or
• Applied to the payment of premiums on life insurance policies on the life of the grantor or the grantor's spouse, other than life insurance policies which are irrevocably payable for charitable purposes. Code Section 677(a)(3).

Each of the specific situations noted above will be discussed in further detail below.

1. <u>Possible or actual income distributions to the grantor or to the grantor's spouse.</u>

Where a trust requires or permits the income to be distributed to the grantor or to the grantor's spouse, the grantor will be treated as the owner of the income portion of the trust, so long as such distributions may be made without the approval or consent of any adverse party. CCA 200445025 (Nov. 5, 2004). Where the grantor's spouse is a discretionary income beneficiary, and the trustee held no beneficial interest so was not an adverse party, the grantor will be treated as the owner of the trust. *Amabile v. Commissioner*, 51 T.C.M. 963 (1986).

The distinction between the presence of adverse parties or nonadverse parties is important. In a situation where the grantor was not entitled to receive the income of the trust under the terms of the trust agreement, but received it anyway based on the consent of all of the beneficiaries, Code Section 677(a) was held inapplicable since the beneficiaries were adverse parties, and but for their approval, no trust income would have been payable to the grantor. *Commissioner v. Makransky*, 321 F. 2d 598 (3d Cir. 1963). Where a power of appointment is involved, if the grantor can only receive distributions from the trust with the consent of the other potential appointees, they will be considered adverse parties, and the grantor will not be considered the owner of the trust. Priv. Ltr. Ruls. 200731019 (May 1, 2007), 200729025 (April 10, 2007) and 200148028 (August 27, 2001). However, where all of the discretion to make distributions to the grantor or the grantor's spouse is in the hands of a nonadverse trustee, even if the grantor and the grantor's spouse have the right to veto a distribution, that is not viewed as a sufficient power to make the spouses adverse as to each other. Consequently, the grantor will be treated as the owner of the trust. Reg. 1.677(a)-1(b)(2); Priv. Ltr. Rul. 9536002 (May 12, 1995)

Example: Grantor creates a trust with First Bank as trustee, providing that income may be paid to Grantor or Grantor's adult children as the trustee determines in the trustee's sole discretion. All income is paid to Grantor's adult children during the year in question. Since the income could have been paid to Grantor in the discretion of a nonadverse party (First Bank), Grantor is taxable on all of the trust income.

2. <u>Trust income being held or accumulated for future distribution to the grantor</u>.

Grantor trust treatment will result if the income of the trust may be accumulated without the consent of an adverse party for future distribution to the grantor or to the grantor's spouse. Code Section 677(a)(2).

It is not unusual for a trust to exist where the grantor has retained some form of a reversionary interest and income arises (typically capital gains allocable to the principal of the trust) throughout the duration of the trust. Since the trust principal is being held for future distribution to the grantor, whatever income that accrues to principal, whether under the governing trust instrument or under local law, is treated as being accumulated for future distribution to the grantor, even if no other interest or power would cause grantor trust exposure. In such a case, even though the grantor may not be considered the owner of the income portion of the trust (perhaps because the value of the grantor's reversionary interest falls below the five percent threshold set forth in Code Section 673) the grantor will be taxed on the trust income being accumulated for the grantor's benefit. This, in turn, may cause a cash flow hardship to the grantor, since this income may not be currently available for distribution to the grantor. *Duffy v. United States*, 487 F.2d 282 (6th Cir. 1973); cert. denied, 416 U.S. 938 (1974); Reg. 1.677(a)-1(g), Ex. 2; Rev. Rul. 79-223, 1979-2 C.B. 254; Rev. Rul. 75-267, 1975-2 C.B. 225.

3. Trust income used to pay life insurance premiums on the life of the grantor or the grantor's spouse.

The grantor of a trust is treated as the owner of any trust or portion of a trust the income from which can be used, without the consent of an adverse party, to pay the life insurance premiums on the life of the grantor or the grantor's spouse, unless the insurance proceeds are irrevocably payable for a charitable purpose specified in Code Section 170(c). Code Section 677(a)(3). The trust does not have to direct that the trust income be used to pay life insurance premiums. The fact that trust income is (or may be) actually used for this purpose is sufficient to make the grantor the owner of the portion of the trust allowing income to be so used. Reg. 1.677(a)-1(b)(2).

A series of older decisions took the view that the trust must actually own policies for Code Section 677(a)(3) to be applicable. According to these cases, the amount of income on which the grantor may be taxed is limited to the income actually used by the trustee to pay premiums on the policies held by the trust. *See*, e.g. *Commissioner v. Mott*, 85 F.2d 315 (6th Cir. 1936). A contrary view from the IRS later emerged in a series of private letter rulings suggesting that a mere premium payment power would be sufficient to cause a trust to be a wholly owned grantor trust. *See* Priv. Ltr. Ruls. 8852003 (Aug. 31, 1998) (holding that a power to pay premiums alone causes the entire trust to be a grantor trust) and 8839008 (June 23, 1988) (the IRS determined that it is immaterial whether the premium payments come from the income or principal of the trust for trust accounting purposes). The trustee's power to purchase life insurance on the life of the grantor or the grantor's spouse and pay the life insurance premiums coupled with the actual payment triggered the finding of grantor trust status.

Example: George owns a $500,000 life insurance policy on his life. He transfers it into an irrevocable trust for the benefit of his two children. He also transfers income producing property to the trust so that the trustee (Second Bank) can use the income to pay the premiums on the life insurance policy. In addition, George's spouse, Denise, also transfers income producing property to the trust. George will be taxed on the income generated by the property that he transferred to the trust because that income is being used to pay premiums on his life insurance. Denise will be taxed on the balance of the income (the trust income generated by the portion of the property Denise transferred to the trust). Because Denise transferred property to the trust, the income from which is being used to pay premiums on the life insurance on the life of her spouse, Denise is treated as the grantor of that portion of the trust to the extent of the property she contributed to the trust.

C. Using Trust Income to Satisfy the Grantor's Obligation of Support

The possibility that trust income may be used to discharge the obligation of the grantor or the grantor's spouse for support and maintenance of a trust beneficiary is not sufficient to cause the income of the trust to be taxed to the grantor. Instead, Code Section 677(b) provides a rather broad exception to the general rule of Code Section 677(a) discussed above. Trust income will not be considered taxable to the grantor merely because such income in the discretion of another person, or the trustee, or the grantor acting as trustee or co-trustee *may* be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain—*except* to the extent that such income is so applied or distributed. Code Section 677(b). In the absence of the grantor's legal support obligation and in the absence of the grantor's nonfiduciary power to direct discretionary distributions, simply distributing trust income to a relative of the grantor (such as a child who the grantor is not obligated to support) will not trigger grantor trust status under Code Section 677(a).

The general rule of Code Section 677(a) (taxing the grantor on the trust income) and not the exception of Code Section 677(b) will apply if the discretion to apply or distribute trust income rests solely in the grantor, or in the grantor acting in conjunction with other persons, unless the grantor's discretion must be exercised as a trustee or as a co-trustee. Reg. 1.677(b)-1(e). Moreover, the general rule of Code Section 677(a) and not the exception of Code Section 677(b) will apply to the extent that the trust income is required, without any discretionary determination being made, to be applied to support a beneficiary whom the grantor is legally obligated to support. Reg. 1.677-1(b)-1(f). In that case, the grantor will be taxable on that part of the trust income required to be paid and applied, as well as any additional amounts that were actually paid and applied in discharge of the grantor's support obligation.

Example: Hugh creates a trust for the benefit of his minor daughter, Sharon. The trust provides that the trustee may, in the exercise of the trustee's discretion, pay income to or for the benefit of Sharon for her health, education, maintenance and support. Hugh's brother, Paul, is named trustee of the trust. In the first five years of the trust's operation, no income is paid to Sharon and the income is accumulated in the trust. The income is taxable to the trust, not to Hugh, as the exception contained in Code Section 677(b) applies. In year 6, Paul distributes all of the trust income for Sharon's benefit (assume she is still a minor) to pay for her medical expenses. The year 6 income is taxed to Hugh, since it has been used to discharge his obligation to support his daughter. At the end of year 6, Hugh removes Paul as the trustee of the trust, and names himself as the trustee. In years 7 and 8, no distributions are made from the trust as the income is again accumulated. Even though Hugh is the trustee, he is not taxed on the income since he is acting in a fiduciary capacity, and no distributions were made to satisfy his support obligation. In years 9 and 10 (assume Sharon is still a minor) Hugh uses the trust income to pay for a variety of Sharon's basic living expenses. Here, Hugh is taxed on the trust income even though he is acting in a fiduciary capacity, since he is using the income of the trust to satisfy his obligation of support, so that the exception of Code Section 677(b) is inapplicable, and the general rule of Code Section 677(a) now applies.

D. Determining the Grantor's Support Obligation

There are no rules in the Internal Revenue Code and no federal standard that defines what is meant by a legal obligation of support. The regulations only provide that the grantor's legal obligation of support is to be determined under local law. Reg. 1.662(a)-4. State laws vary widely in determining when a support obligation arises, and will be determinative of the extent of a parent's obligation. Rev. Rul. 56-484, 1956-2 C.B. 23. In most states parents have an obligation to provide support for children until age eighteen is attained, regardless of the resources of the child, but some states extend the support obligation to age twenty-one.

Payments of income received under statutes such as the Uniform Transfers to Minor's Act are taxable to the grantor when deemed to satisfy a support obligation. Rev. Rul. 59-357, 1959-2 C.B. 212; Rev. Rul. 56-484, 1956-2 C.B. 23. The cases addressing the support issue have not been uniformly decided. Private school tuition, music and dancing lessons were not support obligations under South Carolina law, so the grantor was not taxable on the income of a trust created to provide for these items. *Wyche v. United States*, 36 AFTR2d 75-5816 (Ct. Cl. Tr. J. 1974). College education expenses for emancipated children and private school expenses for minor children were found to be within the scope of a parental support obligation of a financially capable parent under New Jersey law so that the income of trusts used to provide for these expenses was taxed to the grantor. *Braun v. Commissioner*, 48 T.C.M. 210 (1984). A California parent was found to have an obligation to provide a private school education for a minor child. *Stone v. Commissioner*, 54 T.C.M. 462 (1987), *aff'd*, 867 F.2d 613 (9th Cir. 1989). Montana law does not establish a parental obligation to provide private school, musical instruments, or music, swimming, and public speaking lessons. *Brooke v. United States*, 300 F. Supp. 465 (D. Mont. 1969), *aff'd*, 468 F.2d 1155 (9th Cir. 1972). A different type of analysis was applied in *Morrill v. United States*, 228 F. Supp. 734 (D. Me. 1964) where it was found that a grantor had a contractual obligation (based on agreements executed) for private school tuition and other expenses for music and dance lessons, special camps, etc., so that using trust income to address these obligations rendered the grantor taxable on the trust income since the grantor's contractual obligation was discharged by the distributions from the trust.

IX. Code Section 678 – A Person Other than the Grantor Treated as Substantial Owner of the Trust

A. General Rules and Background of Code Section 678

A person other than the grantor of a trust, including a beneficiary, may be treated as the owner of any portion of a testamentary or inter vivos trust over which such person has a power, exercisable solely by himself or herself to vest the corpus or the income of the trust in himself or herself. Code Section 678(a)(1). The rule applies whether or not the power is exercised. Rev. Rul. 67-241, 1967-2 C.B. 225.

The power to vest the principal or income of a trust in oneself makes the holder of that power taxable as the owner of the trust under Code Section 678(a) only if the power is exercisable by the holder alone. If the consent of any third party is required for the exercise of the power, Code Section 678(a) does not apply, regardless of whether the third party who must consent is adverse or not. Accordingly, if a trust provides that a trustee may distribute the trust principal to himself or herself only with the consent of an adverse party, the trustee is not treated as the owner of the trust under Code Section 678(a). Priv. Ltr. Rul. 8926032 (March 31, 1989). If an actual distribution of trust income is made to such person, that person will be treated as a beneficiary of the trust under the standard beneficiary rules of Subchapter J, Code Sections 661 and 662, but not as the owner of the trust within the rules of Code Section 678(a). Priv. Ltr. Rul. 8213140 (Dec. 31, 1981).

In addition, a person other than the grantor of a trust will also be treated as the owner of any portion of a trust as to which although the person has previously modified or partially released a power to vest the trust principal or income in himself or herself, the person has still retained such control over the trust that would, had the power been retained by the grantor of the trust, cause the grantor trust rules as set forth in Code Sections 671 through 677 to be applicable. Code Section 678(a)(2); Reg 1.678(a)-1(a). The effect of Code Section 678(a)(2) is to treat a person who has modified or released a Code Section 678 power as though that person is the creator of the continuing trust. Powers that lapse may also be included within the reach of Code Section 678(a)(2).

A person with the power to vest in himself or herself only the fiduciary accounting income of a trust will be treated as the owner of only the ordinary income portion of the trust. If a person has the power to vest in himself or herself all of the trust principal, that person will be treated as the owner of the entire trust. Regs. 1.671-3(b)(1) and 1.671-3(b)(3).

Code Section 678 arose from the case of *Mallinckrodt v. Nunan*. 146 F.2d 1 (8th Cir. 1945), *cert. denied*, 324 U.S. 871 (1945). The case held that the beneficiary's unrestricted access to the trust property was the trigger for finding grantor trust status for the beneficiary. The case involved a trust beneficiary who was entitled to receive whatever portion of the trust income that he might request. The beneficiary was also a co-trustee with broad management powers, and had the right to terminate the trust at any time and receive the entire trust estate. The court found that the possession of the demand power over the trust income was so significant that the possessor of the power should be considered the taxpayer. This was the result, even if the income not demanded by the beneficiary during the year was added to trust principal at the end of the year, thereby putting the foregone income out of the beneficiary's control.

Example: Joanne created an irrevocable trust which provided that Bill was the income beneficiary for his lifetime, remainder to Cheryl in the event of Bill's death. The trust gave Bill a general power to appoint the trust income or principal to himself or his estate at any time during his lifetime or by his will. As the result of this power, Bill will be treated as the owner of the trust under Code Section 678(a). Rev. Rul. 67-241, 1967-2 C.B. 225.

Example: Terry created an irrevocable trust with separate shares for each designated trust beneficiary. The trust provided that any beneficiary who had attained age 30 had the right to withdraw some or all of the trust principal, but those beneficiaries who had not yet attained age 30 did not possess this right. Those beneficiaries over age 30 would be taxed as owners of the trust income and principal under Code Section 678(a), but those beneficiaries under age 30 would not be taxed as owners of the trust. *See* Priv. Ltr. Rul. 8545076 (Aug. 14, 1985)

A person will be treated as the owner of a trust under Code Section 678(a) if that person has a power exercisable solely by himself or herself to apply the trust income or principal in satisfaction of his or her legal obligations, other than the obligation to support a dependent. Reg. 1.678(a)-1(b). In such a case involving dependents, the person will be taxable as the owner of the portion of the trust that can be so used.

B. Obligations of Support

A person will not be taxable as the owner of a trust under the general rules of Code Section 678(a) if that person, acting in the capacity as trustee or co-trustee, holds a power to apply trust income for the support and maintenance of another person whom the holder of the power is legally obligated to support or maintain. Code Section 678(c). However, to the extent that a person, acting in the capacity of trustee or co-trustee, applies the income of the trust to the support or maintenance of a person to whom such an obligation is owed, the person acting as trustee or co-trustee will then be considered the owner of the trust. Code Section 678(c); Reg. 1.678(c)-1(a).

Note the parallel here with Code Section 677(b) which provides that a grantor of a trust will not be treated as the owner of the trust merely because the grantor, acting as a trustee or as a co-trustee, *may* apply the trust income for the support and maintenance of a beneficiary whom the grantor is legally obligated to support and maintain—except to the extent the income is *in fact* so applied or distributed. In Private Letter Ruling 8939012 (June 29, 1989), the IRS held that a sole trustee was not taxable as a grantor under Code Section 678 where the beneficiaries of the trust were the adult children and descendants of the trustee to whom no legal obligation of support was owed.

Code Section 678 does not make any reference to an ascertainable standard. However, many planners take the position that a person acting in the capacity of a trustee will not be taxed on the income of the trust under Code Section 678 if the discretion of the trustee is limited by an ascertainable standard. This position is based on the fact that the language of Code Section 678 requires that the trustee be able to vest income or principal in himself or herself "solely by himself," and if a decision as to distributions must be made in accordance with whether an ascertainable standard has been satisfied, the trustee is not making the determination "solely by himself." There is some support for this position in the legislative history of Code Section 678 where it is stated that a person would be treated as the owner of a trust if the person had an "unrestricted power to take the trust principal or income." S. Rep. No. 1622, 83d Cong., 2d Sess. 87 (1954).The obligation to apply an ascertainable standard has been viewed as a limitation on the "unrestricted power" referred to in the legislative history. Where there is an objective standard limiting the discretion of the beneficiary, ownership of the trust by the beneficiary has not been found. *United States v. DeBonchamps*, 278 F.2d 127 (9th Cir. 1960); *Funk v. Commissioner*, 185 F. 2d 127 (3d Cir. 1950).

If a person, acting in any capacity *other than* as a trustee or as a co-trustee, holds a power exercisable solely by himself or herself to apply trust income to discharge an obligation of support and maintenance for someone such person is legally obligated to support, such person will be treated as the owner of the trust, regardless of whether or not the income of the trust is so applied. In this situation, the general rule of Code Section 678(a) and not the protective exception of Code Section 678(c) is applied. Reg. 1.678(c)-1(b).

However, a power to vest income in oneself as a co-trustee will not be treated as a power "exercisable solely" by oneself. *See also* Priv. Ltr. Rul. 200901030 (Sept. 29, 2008). In *Mesker v. United States,* 261 F. Supp. 817 (E.D. Mo 1966), a husband was found to not be taxable on the income of a trust over which he had the power to direct the trustees to pay the trust income to his wife, since he did not have the power exercisable solely by himself to apply the trust income to discharge his legal obligation to support his wife under state law. He had no power to vest the trust income in himself, so that Code Section 678(a) did not apply, nor did Code Section 678(c), since the husband did not hold the power in the capacity of a trustee or a co-trustee.

Example: Anthony creates a trust for the benefit of his minor grandchild, Jane. Anthony names his daughter, Doris, the mother of Jane, as the trustee of this trust. Doris has the power under the trust document to use the trust income for the support and maintenance of Jane. If Doris does not distribute any of the trust income to or for the support and maintenance of Jane, Doris will not be treated as the owner of the trust. However, if Doris distributes trust income to or for the support and maintenance of Jane, Doris will be treated as the owner of the trust—to the extent of the distributions made for the support and maintenance of Jane.

Example: Assume in the example above that instead of naming Doris as the trustee of the trust, Anthony named First Bank, a corporate trustee, as the sole trustee of the trust, but gave Doris the power to direct that the income of the trust could be used or applied for the support and maintenance of Jane. In such a case, since Doris is not acting in a fiduciary capacity, she would be treated as the owner of the trust and all of the trust income would be taxable to Doris, whether or not she directed that the income of the trust be used for the support and maintenance of Jane.

A power of withdrawal over a trust held by a minor may qualify as a Code Section 678(a) power resulting in the taxation of the minor even if the minor is legally prohibited from exercising that power. A minor beneficiary of a trust was treated as the owner of the portion of the trust with respect to which the beneficiary had the power to vest the principal or income in himself, even though no guardian had yet been appointed for the minor. The position of the

IRS is that it is the existence of a power rather than the capacity to exercise it that determines whether a person other than the grantor shall be treated as the owner of any part of a trust. The minor may not know of his or her rights or have any way of exercising such rights absent the appointment of a legal guardian. Rev. Rul. 81-6, 1981-1 C.B. 385; Priv. Ltr. Rul. 9535047 (June 6, 1995). The courts have found it is the right to receive property from the trust, and not the actual amounts distributed, that controls the issue of who should be taxed as the owner of the trust property. *Spies v. United States*, 180 F.2d 336 (8th Cir. 1950); *Koffman v. United States,* 300 F.2d 176 (6th Cir. 1962). As the result of the 2017 Tax Cuts and Jobs Act, persons subject to the kiddie tax (applicable to most of the unearned income of children under age 19 or children who are full-time students under age 24) will result in much of the child's income being taxed at the tax rates applicable to trusts and estates, and not at their parents' tax rates. Code Section 1(j).

C. Renunciation or Disclaimer of a Power

Code Section 678(a) does not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence. Code Section 678(d); Reg. 1.678(d)-1 What constitutes a "reasonable time" or a valid disclaimer is a matter for determination by state law, since neither Code Section 678 nor its regulations provide any guidelines as to what will constitute a valid disclaimer for these purposes. While Code Sections 2518(a) and 2046 provide substantial guidance with respect to what constitutes a "qualified disclaimer" for federal gift and estate tax purposes (and set a nine-month period commencing at the time of the transfer for qualified disclaimers) they do not apply for income tax purposes. The IRS has taken the position that a trust beneficiary who disclaims the trust income remains taxable on the trust income realized prior to the disclaimer. The disclaimer of a Code Section 678 power did not allow the disclaimant to avoid income taxation on the income earned by the trust prior to the disclaimer. Rev. Rul. 64-62, 1964-1 C.B. 221.

D. Conflicting Powers of Grantor and Power Holder

The general rule of Code Section 678 does not apply with respect to a power over income whether originally granted or subsequently modified if the original trust grantor is otherwise treated as the trust owner under Code Sections 671 through 677. Code Section 678(b).

Trust beneficiaries are often given a right of withdrawal from the trust that is designed to fall within an exception to the estate tax and gift tax inclusion rules. If a beneficiary is given the power to withdraw from the trust on an annual, non-cumulative basis, an amount limited to the greater of $5,000 or five percent of the value of the trust property out of which the power could be satisfied, the lapse of such a power of withdrawal is excluded from the definition of "release" for estate tax purposes under Code Section 2041(b)(2) and for gift tax purposes under Code Section 2514(e).

However, for income tax purposes, the holder of a "five and five" power of withdrawal which lapses if not exercised in any given year is treated as an owner of that portion of the trust principal to which the power applies, regardless of whether or not the power of withdrawal is exercised, provided the holder of the power has retained such other control over the trust as would, if retained by the grantor of the trust, subject the grantor to being treated as the owner of the trust under Code Sections 671 through 677. Reg.1.678 (a)-1(a); Rev. Rul. 67-241, 1967-2 C.B. 225; Priv. Ltr. Rul. 200022035 (March 3, 2000).

A "Crummey power" is used in trust drafting to give a trust beneficiary a limited power of withdrawal over property contributed to the trust (*i.e*., additions made to the trust) for a limited period of time (often 30 days) all in an effort to qualify the beneficiary's right of withdrawal as a present interest for purposes of the gift tax. The Crummey power of withdrawal may apply to the initial funding of the trust as well as to later gifts to the trust. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

As a general rule, the IRS will treat the holder of a Crummey power as the owner of that portion of the trust as to which the withdrawal power applies while the power exists under Code Section 678(a)(1), and as the owner of a portion of the trust after the power lapses if the power holder is also a beneficiary of the trust under Code Section 678(a)(2). This rule will even extend to the case of a minor beneficiary with a Crummey power even though local law legally prevents the minor from exercising the power absent the appointment of a legal guardian. The existence of the withdrawal power, and not the legal ability of the minor beneficiary to exercise it, is viewed by the Service as the determinative factor. Rev. Rul. 81-6, 1981-1, C.B. 385; Priv. Ltr. Rul. 200011058 (Dec. 15, 1999). The withdrawal powers make the beneficiaries taxable as the owners of both the income and principal of their portion of the trust under Code Section 678(a). Rev. Rul. 67-241, 1967-2 C.B. 225.

Technically, each beneficiary may be required to report a portion of the trust income. In Private Letter Ruling 9541029, (July 14, 1995) the IRS ruled that each of seven beneficiaries who had a Crummey power over one-seventh of the contributions to the trust must each include those items of income, deduction and credit against tax attributable to or included in the portion of trust principal over which each beneficiary had a right of withdrawal during that calendar year.

The above discussion of the possible trust ownership status of the holder of a Crummey power suggests that situations may exist where a trust may appear to have multiple owners, especially where the grantor has retained powers over the trust, but has allowed another person to have powers (such as a Crummey power of withdrawal) over the trust as well. Code Section 678(b) resolves this dilemma at least in part as it provides that if a person (who is not the grantor) holds an original or subsequently modified power over the income of the trust, and the grantor of the trust is otherwise treated as the owner of the trust under Code Sections 671 through 677, then Code Section 678(a) does *not* apply with respect to such non-grantor person.

In effect, the presence of a "true" grantor "trumps" the status of a power holder as a potential grantor. There is not a shared grantor status in these situations. Code Section 678(b); Reg. 1.678(b)-1. The IRS has issued a number of private letter rulings holding that the grantor trust provisions will "trump" a Code Section 678(a) power attributable to a person holding a Crummey withdrawal right that lapses. The original grantor of the trust has been held to continue to be treated as the "owner" of all of the trust income and principal despite the existence of a Crummey clause in the trust giving other persons rights over the trust. Priv. Ltr. Ruls.

200729016 (March 27, 2007), 200603040 (October 24, 2005) and 200011054 (December 15, 1999).

Code Section 678(b) is necessary to prohibit a trust grantor who retains one or more grantor trust powers from allowing another person to have a power described in Code Section 678(a) and thereby shift the tax consequences of the trust to such person. If this could be done, grantors could create appropriate powers in low-bracket taxpayers which would most likely never be exercised, but would have the effect of allocating some of the trust's taxable income to such low-bracket persons. This would obviously undermine the intent of the grantor trust rules.

Example: Gina creates a revocable trust and gives Betty, the trust beneficiary, the power to demand annual distributions of the income of the trust. Since the trust is revocable, causing Gina to be treated as the trust grantor under Code Section 676, all of the trust income is taxable to Gina, even if Betty exercises her power of withdrawal and receives the trust income.

The literal language of Code Section 678(b) and Regulation Section 1.678(b)-1 does not end the discussion of this issue, however, since it addresses only a power over *income*, and many withdrawal powers over a trust, including Crummey powers, may also address powers over the trust principal. There is some useful guidance in the legislative history of these provisions where it is stated, "A person other than the grantor may be treated as a substantial owner of a trust if he has an unrestricted power to take the trust principal or income . . . unless the grantor himself is deemed taxable because of such a power." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 63 (1954); S. Rep. No. 1622, 83d Cong. 2d Sess. 87 (1954).

Numerous commentators have cited this language and suggested that the power "over income" reference was a drafting error and should be disregarded, since Code Section 678(a) applies to powers over income and principal, or that the reference to "income" is broadly meant to refer to "taxable income," and not narrowly to trust accounting income. In its Private Letter Rulings, the IRS has not made a distinction between the power over income and the power over principal. Priv. Ltr. Ruls. 200840025 (June 13, 2008), 200732010 (May 1, 2007), In these rulings, the IRS often cites Regulation Section 1.671-2(b) referring to "income" as taxable income, not trust accounting income, without making any distinction between the ordinary income and capital gains of the trust. If different persons (the grantor and the beneficiaries) had specific and possibly separate rights in trust accounting income and/or trust accounting principal, a "shared" trust ownership may be a reasonable conclusion here. Without such clear distinctions, the "power over income" is likely to continue to be interpreted to refer to a power over income and principal.

X. Using the Grantor Trust in Tax Planning Situations

The grantor trust has become an especially useful and popular device for tax planning in many different contexts. While a non-grantor trust that does not distribute its income is subject to the highly compressed income tax rates imposed on trusts and estates, the income of a grantor trust is taxed at the tax rate of the individual grantor, which is typically much more favorable.

Some of the planning techniques that feature grantor trusts are discussed briefly below.

A. The Revocable Trust

A revocable trust is the most commonly used form of grantor trust. Often called a "living trust," the revocable trust allows the grantor to transfer assets to a trust while retaining the right to income from the trust and control over the trust assets. The revocable trust is a grantor trust under the rules of Code Section 676. In those states where probate is cumbersome and/or expensive, the revocable trust is often the centerpiece of an estate plan, as it allows the grantor to control assets while living and pass assets at death to heirs through the trust without being subjected to probate administration. Most states treat a will as a public document, and some state laws make public an inventory of a decedent's assets that pass through probate. The use of the revocable trust in these jurisdictions allows a grantor and the grantor's family to maintain privacy after the grantor's passing with respect to the grantor's assets.

Even where probate administration and privacy are not serious issues, a revocable trust is often used as a management vehicle for the grantor's assets. Perhaps the grantor is aging, and becoming less comfortable or capable of managing his or her assets. Placing those assets in a revocable management trust allows the grantor not only to remain in control of those assets as the trustee of the trust for as long as possible, but also to name a co-trustee or successor trustee to assist in management or to take over management, as the case may be. This planning may allow for an easy transition of control should the grantor become incapacitated without the need to have conservators or guardians appointed to manage the grantor's property. When the grantor dies, the fiduciaries are in place, the assets titled in the name of the trust are well-organized and easily identifiable, so that management of the grantor's estate can proceed efficiently.

If a person has real estate holdings in more than one state, a revocable trust is often a good way to hold title to those properties. If the grantor dies, instead of having to address ancillary probate proceedings in each state to transfer title from the grantor's name to the names of the grantor's heirs, the title in the name of the revocable trust is undisturbed and the trust beneficiaries can enjoy the property without the requirement of potentially cumbersome and expensive ancillary probate administrative proceedings.

From a tax perspective, the revocable trust is generally treated as the alter ego of the grantor. The taxable year of the trust and method of accounting used must follow those used by the grantor. Rev. Rul. 57-390, 1957-2 C.B. 326. All of the income of the trust is taxable to the grantor. There is no gain or loss recognized and no change to the income tax basis of the grantor's assets when those assets are placed in the trust. If a transfer is made by the grantor to the trust, it is not a taxable gift, since the grantor retains the right to revoke the trust. If the trust makes a gift to a third party, it is treated as a gift from the grantor individually to such third party. If the grantor of a revocable trust dies, all of the trust property is included in the grantor's taxable estate by reason of the grantor's right to revoke the trust. Code Section 2038.

When the grantor dies, the trust will cease to be characterized as a grantor trust. It will then be subjected to the general rules of trust income taxation as provided by Subchapter J of the Internal Revenue Code. However, a revocable trust is eligible to make an election under Code

Section 645 to be taxed as if it were part of the grantor's estate for the greater of two years from the grantor's date of death or the period necessary to resolve any federal estate tax proceedings. Such an election is recommended (File Form 8855 by the due date of the estate's first fiduciary income tax return) as the laws addressing estate income tax administration are somewhat more favorable than those available in the case of a trust's income tax administration.

Other income tax rules which would apply to the grantor as an individual remain applicable even though the grantor's property has been transferred to a revocable trust. The grantor can continue to claim itemized income tax deductions for home mortgage interest (Code Section 163) and real property taxes (Code Section 164) to the extent permitted after the 2017 Tax Cuts and Jobs Act even though the property is titled in the name of the revocable trust. Priv. Ltr. Rul. 9516026 (Jan. 19, 1995). The exclusion of gain from the sale of a principal residence available under Code Section 121 remains available to the grantor and the grantor's spouse even if the residence is held in a revocable trust at the time of the sale, assuming, of course, that the ownership and use requirements of Code Section 121 are satisfied. Priv. Ltr. Rul. 199912026 (Dec. 23, 1998).

Transferring Series E or Series EE U.S. Savings Bonds with untaxed interest to a revocable trust does not accelerate taxation of the deferred income on the bonds. Rev. Rul. 58-2, 1958-1 C.B. 236; Priv. Ltr. Rul. 9009053 (Dec. 6, 1989). A grantor who suffers an involuntary conversion of real property can use the deferral of gain provisions of Code Section 1033 even if the property is titled in the name of a revocable trust. Rev. Rul. 66-159, 1966-1 C.B. 162. Similarly, where a grantor owned property individually that was the subject of an involuntary conversion and later made the qualifying replacement property acquisition by using a grantor trust, the Service concluded that the trust's status would be disregarded for income tax purposes, and the grantor is considered to have purchased the property, thereby satisfying the requirements of Code Section 1033. The trust was viewed as the purchasing and entitling agent of the grantor. Rev. Rul. 88-103, 1988-2 C.B. 304.

A decedent spouse may transfer his or her qualified retirement plan benefits to a grantor trust of the surviving spouse where the surviving spouse is the sole trustee and the current income beneficiary. If the surviving spouse then rolls over the plan benefits to the survivor's own IRA, the transaction will be viewed as a proper tax-free rollover by the surviving spouse. The fact that the plan benefits went from the decedent to the grantor trust to the spouse does not disqualify the transfer from tax-free rollover treatment. Had the trust been a trust other than a grantor trust, the spouse would not have been eligible for tax-free rollover treatment, unless the spouse could show he or she was the sole trustee and sole trust beneficiary with complete discretion over the trust property. Priv. Ltr. Ruls. 9813018 (Dec. 30, 1997) and 9820020 (Feb. 18, 1998).

A grantor may transfer an installment obligation to a revocable trust or may receive an installment obligation from a revocable trust. Neither of such transfers will be treated as a disposition of an installment obligation which would have the effect of accelerating deferred gain. Rev. Rul. 74-613, 1974-2 C.B. 153; Rev. Rul. 73-584, 1973-2 C.B.162; Rev. Rul. 76-100, 1976-1 C.B 123. The transfer of an installment obligation to an irrevocable trust of which the grantor is *not* treated as the owner ordinarily triggers the recognition of gain by the grantor. Rev.

Rul. 67-167, 1967-1 C.B. 107; Rev. Rul. 76-530, 1976-2 C.B. 132. However, a transfer by a grantor to a grantor trust is not a disposition that triggers acceleration of the tax on an installment sale. Instead, the income from the installment obligation remains taxable to the grantor as it is received in accordance with the terms of the installment obligation. Rev. Rul. 67-70, 1967-1 C.B. 106; Rev. Rul. 74-613, 1974-2 C.B. 153.

For purposes of the net investment income tax (Code Section 1411) a grantor trust is not subjected to the trust's threshold for imposition of the tax, but rather the individual grantor is subject to the thresholds applicable to individual taxpayers depending on one's filing status.

A potential drawback to the use of the revocable trust is the requirement that the grantor's assets must be titled in the name of the trust to make the trust effective. Clients must consider the cost and complexity of undertaking and monitoring this complexity versus the probate avoidance, management advantages and privacy protection offered by the revocable trust.

B. The Grantor Trust as a Permitted Shareholder of an S Corporation

Grantor trusts are often used in the context of planning with S corporations since grantor trusts are qualified S corporation shareholders, provided the grantor (or deemed owner of the trust under Code Section 678, if applicable) is an individual who is a citizen or resident of the United States. Code Section 1361(c)(2)(A)(i). The entire trust must be owned by an individual meeting these criteria. If a grantor (or deemed trust owner) dies, and the trust met this test immediately before the grantor's death, the trust may continue to be a qualified S corporation shareholder, but only for the two-year period beginning on the date of the grantor's (or deemed owner's) death. Code Section 1361(c)(2)(A)(ii); Reg. 1.1361-1(h).

The grantor trust is often a far more flexible planning vehicle for owning S corporation stock in a trust than the other trusts permitted to hold S corporation stock, namely the qualified subchapter S trust ("QSST") and the electing small business trust ("ESBT"), which require election notification to the IRS and specific (and in the case of the ESBT, unfavorable) income tax reporting and payment rules.

C. The Grantor Retained Annuity Trust (GRAT)

The acronym "GRAT" refers to a Grantor Retained Annuity Trust. It is an irrevocable trust designed to meet the requirements for retaining a "qualified interest" in the trust. The grantor creates the trust and funds it with whatever property the grantor desires to use, including cash, stocks, bonds, mutual funds, real estate, business interests, etc. Generally, the intent of the GRAT is for the grantor to contribute property to the trust that has meaningful appreciation potential. The grantor of the GRAT retains the right to receive an annuity from the trust. The right to receive trust income makes the trust a grantor trust. Code Section 677. The annuity may take the form of either a fixed dollar amount or a fixed percentage of the initial fair market value of the trust property. Code Section 2702; Reg. 25. 2702-1.

The grantor is making a reportable gift for gift tax purposes of the reminder interest in the property transferred, i.e. the fair market value of the property less the value of the grantor's retained interest. This is not a gift eligible for the present interest gift tax exclusion. It is possible to value the gift to the beneficiaries at zero, eliminating all gift tax liability, if the retained interest by the grantor is substantial enough to zero-out the value of the remainder interest. The goal here is to have significant appreciation of the transferred property so that the trust property appreciates to an extent beyond what must be returned to the grantor, resulting in a transfer tax-free benefit to the remainder beneficiaries. This "zeroed-out GRAT" has been approved by the Tax Court and accepted by the IRS. *Walton v. Commissioner*, 115 TC 289 (2000); *acq*. Notice 2003-72, 2003-44 I.R.B. 964 (November 3, 2003); Reg. 25.2702-2(a)(5).

The annuity is created for a fixed period of years as selected by the grantor. Generally, the selected term is at least two years, and not more than twenty years. Since there are adverse federal estate tax consequences associated with the grantor of the GRAT dying before the end of the GRAT term (i.e. an estate inclusion of an amount necessary to produce the remaining annuity due to the grantor), it is advisable to select a term based on the age and health of the grantor that gives the grantor a reasonable likelihood of surviving the chosen retained interest term. Attention must be given to this "mortality risk." The annuity payments may be made to the grantor monthly, quarterly, semiannually or annually, as desired by the grantor, but in any event the annuity must be payable at least annually.

Since the grantor will be receiving an annuity, it is generally advisable, but not required, that the property selected to fund the GRAT be property that is income producing. Otherwise, principal is returned to the grantor to satisfy the required annual payments, defeating the goal of leaving more appreciated property to the remainder beneficiaries. During the annuity term of the trust, a GRAT is a grantor trust, so that the grantor is taxed on all of the income of the GRAT, whether or not such income is actually received by the grantor. Note that a GRAT is considered to be a 100% grantor trust so long as trust principal can be used to make the required GRAT annuity payments. (Most GRATs are drafted to provide this).

At the termination of the annuity period, the trust property passes to the beneficiaries selected by the grantor, thus avoiding probate issues as well as further transfer taxation (assuming the grantor survived the term of the trust), and ensuring a measure of succession planning desired by the grantor.

The basic "theory" of how the GRAT works and why it may be desirable is that property is transferred to fund a trust and the grantor retains an annuity interest that is calculated based on both the selected qualified retained interest of the grantor and an interest rate prescribed monthly by the IRS (the Code Section 7520 rate), with a remainder interest to pass to designated beneficiaries. The assumption by the government in permitting this planning is that the transferred property will generate a cash flow consistent with the prescribed interest rate, and that the value of the property will not fluctuate. If the property generates a return that exceeds the applicable Code Section 7520 interest rate (sometimes referred to as the "hurdle rate"), either attributable to increased cash flow or capital appreciation, the remainder interest will have been undervalued at the date of creation of the trust, and the remainder beneficiaries will acquire property without additional transfer tax being imposed on the grantor (beyond the original gift tax—or use of the applicable gift tax exclusion—when the trust was created). It is this expectation of future appreciation beyond the gift tax value that was used at the inception of the trust that makes the GRAT a popular planning technique.

D. The Qualified Personal Residence Trust (QPRT)

A Qualified Personal Residence Trust (QPRT) is typically created as an irrevocable trust for gift tax purposes. Since the trust is not revocable, Code Section 676 would not be applicable. However, because the Code treats a grantor as the owner of the trust property under Code Section 677 (by virtue of a retained right to the trust income), under Code Section 675 (by virtue of a retained administrative power over the trust) and under Code Section 673 (by virtue of a possible reversion to the grantor's estate) the trust will be treated as a grantor trust for federal income tax purposes. Once grantor trust status has been determined, the grantor will be able to claim the allowable deductions for taxes, mortgage interest and any other deductions or exclusions arising from the residential property that may be properly chargeable to or excluded from income. Code Section 2702; Reg. 25.2702-5.

Grantors who create qualified personal residence trusts are deemed to be the owners of their entire trusts for income tax purposes under Code Section 673(a). This is because the value of each grantor's reversionary interest in the trust property exceeds five percent of the value of the trust. Accordingly, the grantor is required to include all items of income, deduction and credit against tax attributable to each qualified personal residence trust in computing his or her personal income tax liability. Priv. Ltr. Rul. 9606003 (Nov. 7, 1995).

Example: In a "typical" personal residence trust, the grantor creates an irrevocable trust for the benefit of family members. The grantor transfers her personal residence to the trust, retaining the right to use and occupy the residence for a number of years, which number of years she reasonably expects to survive. If she survives the retained interest term, the residence is then owned by the remainder beneficiaries of the trust (the family members). The grantor is treated as having made a gift of the fair market value of the residence on the date of the transfer, less the value of her retained interest, i.e. a gift of the present value of the remainder interest. Determining these values requires an actuarial calculation. Since the gift to the remainder beneficiaries will only benefit them in the future, when the retained interest term expires, the gift to the remainder beneficiaries is a gift of a future interest, and the grantor may not use her present interest gift tax exclusion to offset any portion of the value of the gift. A gift tax return (Form 709) must be filed for the year the residence is transferred to report the gift. The goal for the QPRT is that the personal residence appreciates beyond its value upon transfer, so that the grantor has made a gift of property "frozen" at the date of gift value less the grantor's retained interest, and worth substantially more when the beneficiaries receive it, with no further transfer tax being due.

If the grantor dies before her retained interest term is exhausted, her death occurred while she retained the right to use and occupy the transferred personal residence property. Accordingly, the fair market value of the transferred property as of her date of death is included in her gross estate for federal estate tax purposes. Code Section 2036. In that case, the basis of the residence to the heirs is the fair market value of the property as of the deceased grantor's date of death.

Code Section 1014(a). If the grantor outlives the retained interest term, and later dies, the value of the residence is not included in her gross estate for federal estate tax purposes, as she did not retain any interest in the transferred property at the time of her death.

E. The Intentionally Defective Grantor Trust

The term "intentionally defective grantor trust" refers to an irrevocable trust that intentionally "violates" one or more of the grantor trust rules. As a result, the income of the trust remains taxable to the grantor. When working with the intentionally defective grantor trust as a planning technique, the general objective is to leave the grantor taxable on the trust income, but make certain that the trust property will not be included in the taxable estate of the grantor.

The rules relating to the taxation of trusts for income tax purposes and for transfer tax purposes are not necessarily consistent. Differences between the transfer tax rules and the income tax rules thus allow a discrepancy to exist—a trust grantor may be treated as the owner of the trust for income tax purposes, but the trust property may be excluded from the grantor's estate for estate tax purposes, so long as certain prohibited retained interests are avoided. This "asymmetrical" tax treatment allows the intentionally defective grantor trust to exist.

Where these circumstances are present, the trust is considered "defective" for income tax purposes (the grantor's transfer failed to relieve the grantor of the income tax obligations of the transferred property). Where the grantor created the trust specifically to achieve this result (in an attempt to accomplish some of the potentially advantageous tax planning objectives described below) the grantor trust is said to be "intentionally defective."

The intentionally defective grantor trust ("IDGT") has a number of desirable tax and estate planning uses. It can be used as an estate freezing technique whereby the value of property transferred by the grantor to the trust is "frozen" as of the date of transfer so that all future appreciation may benefit the trust beneficiaries. Gifts and/or sales to an intentionally defective grantor trust may be used to accomplish this goal. Depending on the assets used to fund the trust, valuation discounts may be available for transfers of partnership, LLC, real estate and closely-held corporate business interests.

IDGTs may also be used as an income tax planning technique. The grantor will transfer property with the intention of removing such property from the grantor's taxable estate. However, the grantor still wishes to be taxed on the income from the trust property for income tax purposes. Having the grantor remain subject to income tax, rather than the trust, serves three purposes. First, it leaves the income taxable to an individual who may be in a lower income tax bracket than the trust. Second, by having the grantor pay the income tax on the trust's income, the trust itself is allowed to grow in value, since the funds necessary to pay the income tax are not being removed from the trust when tax are paid. Accordingly, more funds remain in the trust to pass to the trust beneficiaries. Third, by having the grantor pay the income tax on the trust's income, the grantor's estate is reduced by the amount of income taxes paid by the grantor over the duration of the trust. This is sometimes referred to as "burning" off assets from the grantor's potential estate, a desirable result if the grantor's eventual estate will be large enough to be taxable.

Consider using an IDGT in any situation where the planning goal is to move family wealth from the grantor to the trust and its beneficiaries, including even a simple annual exclusion gift trust for the benefit of children or grandchildren. Leaving the grantor taxable on the trust income is a powerful estate reduction planning tool for the grantor. The former planning "mantra" of shifting taxation of income to persons in lower tax brackets has changed to retaining the income tax burden in the hands of the wealthy senior family member as an effective estate planning strategy.

Broadly stated, to accomplish the planning transaction called a "sale to an intentionally defective trust" a person (the grantor) creates a trust typically for the benefit of children or grandchildren, but retains certain specific and limited administrative powers over the trust. Once the trust has been created, the grantor gives and/or sells assets to the trust.

The grantor may sell assets to the trust in exchange for a long-term interest-bearing installment note. If the transaction is structured properly, the trust grantor has converted an appreciating asset (the asset sold) into an asset with a fixed value (the promissory note); hence the "freeze". The sale transaction is entered into at fair market value, so the sale by the grantor does not result in it being treated as a gift or bargain sale to the trust beneficiaries. The grantor will not be subject to income tax on the sale of the assets to the trust. Why? Because, for income tax purposes, the grantor is treated as the trust owner. See Rev. Rul. 85-13, 1985-1 C.B. 184 (transactions between the grantor and the grantor trust will not have any income tax consequences, since the grantor and the trust are treated as one taxpayer). This allows the sale of assets by the grantor to the trust to avoid capital gains taxes, and the note interest received by the grantor to avoid being subjected to income taxes. Appreciation on the assets sold to the trust grows outside of the grantor's estate. If the grantor dies before the note has been paid in full, only the unpaid note balance is included in the grantor's estate, not the date of death value of the transferred property.

The grantor of an IDGT will not retain any voting, economic or reversionary rights in the assets transferred to the trust. The grantor will not serve as the trustee.

The only gift tax element of this transaction arises from the belief that the trust must be capitalized ("seeded") with sufficient assets (aside from the property being transferred to the trust in exchange for the trust's note) to establish the independence of the trust from the assets to be sold by the grantor to the trust. This gift is considered to be a contribution of equity to the trust to be distinguished from the debt represented by the note arising from the sale of the property to the trust. The capitalization by gift is generally recommended to be at least 10% of the value of the installment note, so that there is a debt (*i.e.*, the amount of the note) to equity (*i.e.*, the amount of the gift) ratio of not more than 10:1. It is important that the trust have independent equity, so that the note owed to the grantor is not recharacterized as an equity interest, which could, in turn, result in the inclusion of the transferred property in the grantor's estate on the theory that an equity interest has been retained in the property sold to the trust by the grantor.

It is crucial to the success of this planning technique that the appropriate grantor power be retained by the grantor. If the power is too “big”, such as the power to revoke the trust, retention of a reversionary interest or permission to receive the trust income, such a retained interest will require inclusion in the grantor’s estate under Code Sections 2036 through 2038. The power to be used must be one “big enough” to leave the grantor taxable on the trust income, but not “so big” as to require inclusion in the grantor’s estate.

Planners typically favor several of the grantor powers discussed earlier in this article to accomplish this goal.

.

Drafters may give the trustee or a non-adverse third party (perhaps a “trust protector”) the right to add a charitable beneficiary. Code Section 674. The grantor should not be the person allowed to possess the power to add beneficiaries. Retaining such a power in the hands of the grantor could cause an inclusion in the grantor’s estate under Code Sections 2036 or 2038. Where this is the power utilized by the grantor, it is recommended that the power granted to the non-adverse party to add potential additional beneficiaries be limited to charitable beneficiaries.

There are several powers set forth in Code Section 675 that are administrative powers which the grantor may retain and thereby be taxed on the income of the trust, but retaining such administrative powers does not rise to the level of requiring inclusion of the trust property in the estate of the grantor. A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. Code Section 675(4). Among the administrative powers satisfying these criteria are the following:

1. The power to borrow the income or principal of the trust, directly or indirectly, without providing adequate interest or without providing adequate security exercisable by the grantor or a non-adverse party will cause the grantor to be treated as the owner of the trust property for income tax purposes. Code Section 675(2). Properly created, this power should not be viewed as creating a threat that the trust property will be included in the grantor’s estate. As a practical suggestion, it may not be advisable to allow the grantor to have the power to borrow without adequate interest, since that may cause the imputed interest rules and Code Section 7872 to apply, resulting in an unwanted complication for the trust. Allowing the grantor to borrow the trust income or principal without providing adequate security will provide the desired grantor trust status and avoid the unwanted estate tax inclusion.

2. The power to substitute trust assets. The power, exercisable by the grantor in a nonfiduciary capacity, to reacquire trust property by substituting other property of an equivalent value will cause the grantor to be treated as the owner of the trust assets for income tax purposes. Code Section 675(4)(C). However, Revenue Ruling 2008-22, 2008-1 C.B. 796 holds that a retained power by a trust grantor, acting in a non-fiduciary capacity, to substitute trust assets for other assets having an equivalent value does *not* cause the trust assets to be included in the grantor’s estate under Code Sections 2036 or 2038.

The ruling indicates that this result will apply *provided* the trustee has a fiduciary obligation (either under local law or required by the terms of the governing instrument) to ensure that the properties acquired and substituted by the grantor are, in fact, of equivalent value, and *further provided* that the power of substitution cannot be exercised by the grantor in a manner to allow the shifting of interests among the beneficiaries of the trust. The trustee must have a duty of impartiality toward the beneficiaries. Where the power of substitution is used as the "defective" retained interest, the grantor should *not* be permitted to act as the trustee. Subsequent to the issuance of Rev. Rul. 2008-22, the IRS issued Private Letter Ruling 200944002 (July 15, 2009) which follows Revenue Ruling 2008-22 and provides a "roadmap" as to how to proceed using a power of substitution.

Taxpayers who created grantor trusts in the years prior to the passage of the 2017 Tax Cuts and Jobs Act may, due to the significant increase in the lifetime exemption amount, now find they have little estate tax exposure but substantial income tax exposure. That being the case, they may wish to relinquish the powers that made the trust a grantor trust and allow the trust (or more likely the trust beneficiaries) to be the income payors. Additionally, there may be a rush to establish non-grantor trusts for families with multiple members to create eligibility for the Code Section 199A deduction where that opportunity was not available to the grantor acting alone as the only income tax payor. As with so many tax planning issues, the circumstances of each taxpayer must be evaluated separately. No advisor should ever assume that "one size fits all" is a correct view of tax planning.

<u>Estate Planning for the Personal Injury Client:</u>

<u>Understanding Disability Benefits</u>

By Karen Dunivan Konvicka, J.D.

Estate planning can encompass much more than taxes. When an injury attorney colleague asks about planning for the client's settlement, be prepared to answer. The foremost issue is determining how it will affect the client's public benefits, if any. If there are benefits to protect, there are planning opportunities; if not, the client may still need the protection of a trust. The immediate questions are: What type or types of benefits is the client is receiving? And will the settlement put these benefits in jeopardy? Perhaps the attorney has not considered benefits but is concerned that the client is incapacitated and will need the assets managed; or perhaps public benefits may be necessary in the future.

How did the client receive benefits — through means-testing or due to work history? Medicaid, the means-tested public health benefit is available for people with disabilities who are also impoverished, which is defined as having less than $2,000 in resources and below 133% of the federal poverty income limit. Personal injury proceeds may not be taxable, but they are countable resources. Medicare, by contrast, is the earned health care coverage received by permanently disabled workers who have worked enough quarters to become eligible. In addition to health benefits, income benefits are available to the disabled. Supplemental Security Income (SSI) is a means-tested benefit just as Medicaid is, whereas Social Security Disability Income (SSDI) is earned income provided to the eligible disabled worker based on the amount withheld from earnings while working.

The Medicare Secondary Payor (MSP) Act, 42 U.S.C. §1395y, requires that an individual receiving compensation for an injury, must use that compensation for the injury related expenses. Medicare, therefore, becomes the secondary payor for these injury related expenses. The MSP has long been enforced for Workers' Compensation awards, and Workers' Compensation attorneys are well versed in the necessity for Medicare Set-Aside (MSA) accounts to manage the proper use and expenditure of the compensation. The Centers for Medicare and Medicaid Services (CMS) has been indicating that it will begin enforcing the MSP for liability cases in the near future. Some clients are eligible for both Medicare and Medicaid. Both can be protected, but not without some planning because an MSA is a countable resource. Adding additional complexity, many plaintiffs are choosing to utilize a qualified assignment of a structured settlement to minimize the tax consequences of growth on the award, *see* 26 U.S.C. 104(a)(2) and 130. While providing important tax benefits to the client, structured settlements also have pitfalls to be avoided when public benefits are involved.

Special Needs Trusts to Protect Public Benefits

The courts have held that not considering and planning for the client's means-tested government benefits can result in a legal malpractice claim, Grillo v. Pettiette et al., 96-145090-92 (96th Dist. Ct., Tarrant Cty., Texas), and Grillo v. Henry Cause, 96-167943- 96, (96th Dist. Ct., Tarrant Cty, Texas), or a breach of fiduciary duty or dereliction of duty if not considered by a fiduciary or denied by a court, Department of Social Services v. Saunders, 247 Conn. 686, 724 A.2d 1093 (1999).

Clients receiving Medicaid, which can come in the form of health insurance benefits, long-term care, and waiver programs for those with intellectual disabilities, family support, technology assistance, home and community- based care, etc., must be advised that receiving the settlement proceeds will endanger these benefits. In the case of waiver benefits, there are often long waiting periods before the individual can receive these waivered benefits again if the client loses eligibility making the timing of the payout and the planning especially important. Creating and funding a special needs trust pursuant to 42 U.S.C. §1396p(d)(4)[1] will preserve these benefits.

Both stand-alone special needs trusts (SNTs) created under (d)(4)(A) and pooled special needs trusts (PSNTs) created under (d)(4)(C) are options to consider. When considering the stand-alone SNT, one must look at the choice of trustee. Banks and trust companies will agree to serve, but consider the cost benefit of these services given the size and value of the trust created. Many require minimum funding and fees can be steep. Family members may agree to serve as trustee, but while the family members usually have good intentions, they may not be equipped to monitor the disbursements for compliance with the complex federal regulations governing public entitlements. Mistakes can cause a period of ineligibility for Medicaid or a reduction in or loss of SSI benefits.

By contrast, PSNTs are administered by a non-profit organization, that works solely for the benefit of disabled individuals, and usually has great expertise in the administration of SNTs and the intricacies of Medicaid regulations and the Social Security Administration's Program Operations Manual System (POMS). Assets in a PSNT are pooled for investment purposes, but each beneficiary has an individual sub-account, allowing investment and management fees to be less than stand-alone trusts. SNTs can be created by the individual, a parent, a grandparent, a guardian, or a court. Although PSNTs can be funded by those who are 65 and older (SNTs cannot), depending on the client's state regulations, there may be a transfer penalty for funding the PSNT when 65 or older.

Finally, a stand-alone SNT must have a repayment provision that requires that the states providing medical services to the beneficiary must be paid back upon the death of the beneficiary. In contrast, the non-profit organization administering the PSNT is allowed to retain the remainder after the death of the beneficiary for the benefit of other people with disabilities. Some pooled trusts retain the remainders, some do not, and some have a hybrid approach. For example, Commonwealth Community Trust (CCT), only retains the remainder if the repayment amount is greater than the balance in the trust. When the repayment is less than remainder, CCT first reimburses the states' Medicaid agencies, and then distributes to the successor beneficiaries. CCT never retains funds if the successor beneficiaries would have received the remainder otherwise.

Medicare Set-Asides Nested within the Special Needs Trust

In February 2017, and again in April 2017, CMS released transmittals[2] requiring Medicare Administrative Contractors (MACs) to deny payment for services related to or associated with an open Liability

---

[1] https://www.govinfo.gov/content/pkg/USCODE-2010-title42/pdf/USCODE-2010-title42-chap7-subchapXIX.pdf.

[2] CMS Manual System, Pub. 100-04 Medicare Claims Processing, Transmittal 3750 (Apr. 19, 2017), https://www.cms.gov/Regulations-and-Guidance/Guidance/Trans.

Medicare Set-Aside (LMSA) or No-Fault Medicare Set- Aside (NFMSA). It warned in these transmittals[3] that CMS will begin denying payment for items and services that should instead be paid by a primary payor such as an insurance company or third party by October of 2020. No transmittal has been released mandating these set-asides nor has a formal process for Liability Medicare Set-Asides been dictated, but the writing is on the wall. Early in 2020, CMS released another article reiterating its position that Medicare should not be billed until any payment from a primary payor has been exhausted.[4]

Adding more planning requirements, an MSA is a countable resource for public benefits purposes and will jeopardize benefits such as Medicaid and SSI with only one possible exception.[5] Careful planning to nest the MSA in a SNT allows management of the set-aside portion of the funds and the remainder of the settlement proceeds, while protecting eligibility for means-tested benefits, and ensuring that injury-related expenses are covered.

Clients not receiving means-tested benefits may ask about self-administering the MSA. While the answer is yes, the recordkeeping and accounting can be complex. The account must be funded either with a lump sum from the settlement or with seed money and subsequent settlement annuity payments. The account must be an entirely separate interest-bearing checking or savings account with no co-mingling of non-MSA funds. Interest earned must also be used for medical expenses related to the injury suffered that would otherwise be covered by Medicare.

Meticulous records of the distributions and expenditures must be maintained. For liability MSAs, accounting is required when the account balance reaches zero while Workers' Compensation cases have annual reporting requirements. Medicare will use this report to confirm that all MSA funds have been exhausted and spent properly before the client can start to submit bills to Medicare. CMS has recovery rights when it has paid where it should not have and can levy damages and suspend Medicare benefits until the funds are paid back.

Weaving in a Structured Settlement

When incorporating a structured settlement into the already complex planning necessary to maintain public benefits and Medicare coverage, there are several issues to consider. Internal Revenue Code Section 104 [6] provides that personal injury settlements for physical injuries are not taxable. Income from those proceeds may be tax-deferred as well, if the settlement is structured pursuant to Internal Revenue Code Section 130.[7] Because of the tax advantages, as well as future financial security in the form of future payments, many cases include a qualified assignment funded by a structured settlement as a part of the mix. The structure can be funded by the defendant's insurance company, but most assign that

---

[3] Dept. of Health and Human Services, CMS, *MLN Matters Number MM9893 Revised*, (Jun. 9, 2017), http://www.mymedlien.com/ wp-content/uploads/2017/06/LMSA-Arti cle-2-CR9893.pdf.

[4] https://www.cms.gov/Outreach-and-Education/Medicare-Learning-Network-MLN/MLNMattersArticles/Downloads/SE17019.pdf.

[5] *Williford v. North Carolina Department of Health and Human Services* (N.C. Ct. App., No. 16-393, Nov. 15, 2016).

[6] Internal Revenue Code § 104-1, *Compensation for injuries or sickness*, https://www.gpo. gov/fdsys/pkg/CFR-2012-title26-vol2/pdf/ CFR-2012-title26-vol2-sec1-104-1.pdf.

[7] Internal Revenue Code § 130, Certain personal injury liability assignments, https:// www.gpo.gov/fdsys/pkg/USCODE- 2011-title26/pdf/USCODE-2011-title26- subtitleA-chap1-subchapB-partIII-sec130.pdf.

liability from their books by purchasing annuities to make the payments. Funding with an annuity is allowed pursuant to Internal Revenue Code Section 130,[8] but the qualified assignment must be done at the time of settlement. The timing and sequence of events are critical. Moreover, the insurance companies selling these annuities must be highly rated by companies such as AM Best and Standard & Poor's.

The choice of trustee may be complicated by a structured settlement. Many bank and trust companies have minimum deposit requirements. PSNTs usually have much smaller initial funding requirements and can accommodate the lower account size over time due to the continuing income stream.

While the initial funding may be payable to the SNT, whether by court order or otherwise, careful attention must be paid to the payee designation in the annuity documents. It must name the SNT as the payee. Many times, the insurance agents writing these annuities are not aware of the devastating effect of naming the beneficiary as the payee rather than the SNT, and the attorneys are concentrating on the court order, which even if correct, does not control the annuity. Once the qualified assignment is made and the annuity purchased, it is irrevocable. If the beneficiary is accidentally named to receive annuity payments in the future, his or her public benefits can be lost for the period of the annuity payments. This period is often years or for the life of the beneficiary. At a minimum, benefits such as SSI and Medicaid would be jeopardized in the months in which payments are received.

SNTs must contain a payback provision to reimburse the states that have provided Medicaid benefits to the beneficiary at the time of the beneficiary's death. Therefore, the contingent or successor payees of the annuity must also be the SNT. Many states have memorialized that requirement in their Medicaid Manuals; however, the prudent course of action, even if in a state that has not, would be to ensure the entire amount of the structured settlement will eventually be paid to the SNT. While naming a successor payee at the death of the beneficiary may be an inventive way to avoid the repayment provision, the provision may cause the loss of means-tested benefits if the beneficiary moves to a state prohibiting such an arrangement.

Finally, if the annuity payments are for a term certain and not just for the life of the beneficiary, then a commutation clause should be included as a part of the annuity contract. A commutation clause provides for a lump-sum payment at the death of the beneficiary based on several different factors decided at the time of the annuity purchase. Receiving the commuted value of the remainder of the annuity at the time of the beneficiary's death allows for the orderly administration and winding up of the SNT. The states' Medicaid departments can be repaid, and any remaining assets in the trust can be distributed to the successor beneficiaries immediately. Fees and administrative costs necessary to leave the trust open while annuity payments continue are unnecessary, but most insurance companies require a commutation clause to commute the value of an annuity.

---

[8] *Id.*

4 Reasons Why Now is the Best Time to Gift a Closely Held Business

By Audra Moncur, CPA/ABV

Gifting of stock in a closely held business is often a good technique in transferring assets out of someone's estate if they are concerned it will be subject to estate taxes in the future. Gifting when the value of the stock is at a low maximizes the benefit of gifting. Future uncertainty causes stock values to decrease, so now is a great time to consider a gifting plan!

Let's dig into the opportunities and what we can discuss with our clients.

1. COVID-19 means there's never been a better time to keep company growth out of the estate

When an estate gets close to taxable estate limits, a good tax-planning strategy is to keep the growth of the business out of the estate — and thus reduce estate taxes. Any growth in a company's value after the date of the gift stays out of the estate.

Gifting to children right now is especially ideal because the COVID-19 pandemic has driven down the value of many companies. And it's done so in four different ways:

1. Businesses are seeing lower actual or projected revenue due to the pandemic's impact, which drives down value.
2. Businesses have increased their interest-bearing debt in order to pay employees and other fixed expenses, and debt reduces a company's value.
3. Businesses have seen a decrease in the value of tangible assets such as inventory, machinery, equipment and real property due to changes in market demand and occupancy rates.
4. Businesses have seen value decrease because of lack of control and lack of marketability discounts due to liquidity issues in the market.

There are three benefits to gifting when the business's value is lower. One, less of the total estate exemption will be used, and that will allow other assets to be transferred without tax implications. Two, more of the business can be gifted without tax impact. And three, the COVID-19 pandemic is not going to last forever, and business values will rebound, so by gifting now, the value appreciation is out of the estate.

2. Potential changes to the lifetime exemption

Under current U.S. tax laws, the lifetime gift exemption is $11.58 million for an individual. A married couple have a combined lifetime exemption of $23.16 million. The current lifetime exemption is set to decrease in 2026. Given how low tax rates are and how high exemptions are right now, we're almost guaranteed to see changes at any time. There is uncertainty of when changes may happen but with the president, senate and house of the same party it is more likely to happen in the future then at any other time. By acting now, we can assist our client in taking advantage of low tax rates and high exemptions while they still can.

It's also important to be aware that Congress and future presidents could limit the discounting strategy we discuss below in section #4. A proposed IRC 2704 regulation would have limited discounting options, but it was stopped with the 2016 change in U.S. presidents. The idea of limiting discounting could arise again. This is yet another reason to act now while things are still certain.

3. The annual gift tax exemption is $15,000 per person and doesn't count toward your lifetime exemption

As of 2020, an individual can give up to $15,000 per year to one or more people. If married, a combined $30,000 can be gifted to one individual. Annual gifts that qualify under this gift-tax exclusion do not reduce the lifetime estate or gift tax exemptions.

For example, parents with four children could transfer interest in their business that totals $120,000 ($30,000 X 4) this year without reducing the $11.58 million lifetime exemption. With the discounting discussed in section #4 below, the $120,000 represents a much larger value to the children. For example, at a 30% discount rate, the $120,000 will really represent $171,429 rounded ($120,000/70%).

The disadvantage of gifting the annual exemption amount each year is that the growth of the business remains in the estate. But if the company value is small, this may be a good approach to consider.

4. The discounts for lack of control and lack of marketability allow more assets to be transferred out of the estate

When a privately held company is sold or gifted, the value of the company may be reduced by the lack of control and lack of marketability discounts. These discounts are due to 1) the inability of a minority shareholder to sell their stock and 2) the lower price someone would pay for that stock if they don't have control of the business.

With these discounts, more stock can be transferred to children under the gifting limits and more assets will be out of the estate. It is better to transfer a minority interest in a company than to transfer undiscounted cash.

Discounts for lack of control and marketability are dependent on many variables but can range from 10% to 25% each.

By taking advantage of the discount for lack of control and discount for lack of marketability, plus the annual donee exclusion, with the spouse, there can be sizable estate and gift tax savings.

Example of the opportunity in action

Let's say, for example, that Mr. and Mrs. Smith own a 100% interest in a closely held business. In 2020 the company operations were impacted and there was a drop in value, which was followed by a rebound in 2021 and 2022.

Using an estimated 15% minority discount and a 20% marketability discount, you can see the impact in gifting a closely held minority interest. In 2020 by taking advantage of the minority and marketability discounts, there is a savings in the use of the lifetime exemption of $4,800,000. Additionally, by gifting when the company value is down, there is a savings of $1,600,000 from the 2021 value and $2,560,000 from the 2022 value. Clearly, the biggest impact in the use of the lifetime exemption is gifting when the company value is down and when the discounting options are still available.

ABC Company				
Gifting Scenario				
		2020	2021	2022
Value of ABC's Equity on a Controlling, Marketable Basis		$ 15,000,000	$ 20,000,000	$ 23,000,000
Minority Discount	15%	2,250,000	3,000,000	3,450,000
Conclued value of Equity on a Minority, Marketable Basis		12,750,000	17,000,000	19,550,000
Marketability Discount	20%	2,550,000	3,400,000	3,910,000
Conclued value of Equity on a Minority, Nonmarketable Basis		$ 10,200,000	$ 13,600,000	$ 15,640,000
Gift 25% each to 4 children	(1)	10,200,000	13,600,000	15,640,000
Combined Annual Gift - 4 children	(2)	120,000	120,000	120,000
Use of Lifetime Exemption with discounts		$ 10,080,000	$ 13,480,000	$ 15,520,000
Gift of 25% to 4 children without discounts		15,000,000	20,000,000	23,000,000
Combined Annual Gift - 4 children	(2)	120,000	120,000	120,000
Use of combined Lifetime Exemption w/o discounts	(3)	14,880,000	19,880,000	22,880,000
Use of Lifetime Exemption without discounts		14,880,000	19,880,000	22,880,000
Use of Lifetime Exemption with discounts		10,080,000	13,480,000	15,520,000
Benefit of discounts on Lifetime Exemption		$ 4,800,000	$ 6,400,000	$ 7,360,000

(1) A 25% interest is a minority interest and in total 100% of the company value is gifted
(2) $15,000 per individual - $30,000 each for 4 children = $120,000 - assumed no change in future years
(2) Mr. and Mrs. Smith don't exceed the joint lifetime exemption of $23.16 million

Hire a qualified business valuation appraiser

One of the requirements of the IRS is hiring a qualified appraiser. It is important that the appraiser has earned an appraisal designation from a recognized professional appraisal organization (such as the ASA, NACVA, IBA, or AICPA). Engaging the right specialist in business valuation is important. Qualified appraisers include a certified public accountant (CPA) accredited in business valuations (ABV), a certified business appraiser (CBA), certified valuation analyst (CVA) or an accredited senior appraiser (ASA).

Conclusion

Now is the time to transfer family wealth when business values are down and tax exemptions are high. Once the impact of the COVID-19 pandemic comes to an end and the economy begins to improve more and more, company values will increase. Start discussions with your clients on this great tax-planning opportunity. This could be the best time to gift stock in a closely held company.

Audra Moncur, CPA/ABV leads Wipfli’s valuation services group in Illinois and works with clients and attorneys to provide business appraisal services for the purposes of litigation support, buying or selling businesses, divorce, and estate planning or gifting.

The Improved Power to Plan: NY Amends Its Power of Attorney Forms and Laws

Brian M. Balduzzi, Esq., Tax LL.M., MBA, CFP®
Alan D. Kroll, Esq.

As advisors, we are often charged with the implementation of our best-laid plans for our clients. Who hasn't experienced the frustration and confusion when one of our planning documents is submitted to a financial institution and rejected, perhaps with little or no explanation? How much do we wish that we had better solutions and recourse for the acceptance of our planning? Fortunately, in 2021, we have additional power to plan for our powers of attorney in New York.

On December 15, 2020, New York Governor Andrew Cuomo signed a significant and timely change to the New York law governing Powers of Attorney ("POA"), effective June 13, 2021. While this new law does not affect the validity of any existing, valid short-form statutory POA or gift riders before the effective date, attorneys and clients should be aware of these changes and potentially useful estate planning opportunities under the new law.

Some of the most impactful changes under the new law include: permitting POA that "substantially conform" rather than with exact wording; allowing a disinterested person to sign the POA at the principal's direction; and incorporating gifting into the POA rather than by a separate, statutory gift rider, perhaps the most important change. The law also changed the procedures for accepting or rejecting POAs by designating the relevant response period, the available response options, reasonable reliance by third parties, and the principal or agent's potential recourse for the unreasonable rejection of a valid POA by a third party.

These changes help attorneys and clients more easily draft POAs and allow third-parties to rely more effectively upon the POA's validity. These changes create meaningful planning opportunities for individuals and families in 2021, encouraging clients and their attorneys to review this new law and clients' wishes and documents.

Statutory vs. Non-Statutory, What's in a Name?

The new law expands the definition of "power of attorney" to include both statutory short form and non-statutory powers of attorney. This statutory short form permits powers of attorney that substantially conform to the wording of the form, rather than exact wording requirements.

One example of substantially conforming is that any section labeled "Optional" may be omitted and replaced with the words "Intentionally Omitted." The power of attorney may also substantially conform even if it uses words that are similar but not identical to the statutory form. A power of attorney will not fail to conform when it does not include or exclude a particular clause. This expansion of the permissible statutory short form allows attorneys and clients to draft more clearly and more concisely, and, therefore, help third parties more readily accept these POA.

Accepting the Powers

In addition to improving what qualifies as a POA, the procedures for accepting (or rejecting) a POA have also been streamlined. Third parties who act in good faith may rely upon a notarized POA, unless they have actual knowledge that the signature was not genuine or the POA was void, invalid, or terminated. If the third party is uncertain of the POA's validity, the third party may also request an agent's certification or counsel's opinion. The third party has only ten days to respond by accepting the POA, rejecting it in writing, or requesting a certification or opinion. The third party must also respond by accepting or rejecting the POA within seven days after receiving the certification or opinion. These changes ensure that the principal or agent has the causes for rejections in writing, an opportunity to respond, and a limited waiting window for the third party's responses.

Furthermore, following the rejection of a POA, if a principal or agent brings an action to compel the third party to accept the POA and the court finds the rejection unreasonable, then the principal or agent may recover damages, including reasonable attorneys' fees and costs. The prior law outlined some of these reasonable causes for rejection, and the new law expanded this list to include the refusal of a request for certification or opinion of counsel.

These changes in the acceptance procedure ensure the necessary communication; clear options for submitting or reviewing POAs; and the third party's timely acceptance, rejection, or request for more information for the POA.

Execution of the Powers

The new law also modified the signature requirement for executing a POA. Now, principals may either sign or initial, or direct a disinterested third party to sign the POA in the principal's presence. This additional execution option helps principals who may have disabilities that inhibit them from physically signing but who can effectively direct another person to sign on their behalf. The POA's execution is further streamlined by eliminating the statutory gift rider as a separate document and, instead, incorporating an "optional" gift transaction clause. More options for executing POAs, along with a more incorporated document, allow attorneys and clients to ensure that the principal's wishes and directions are followed. Furthermore, additional formalities, such as the need for notary publics and witnesses, are minimized with the incorporation of the gift transaction clause, rather than a separate, statutory gift rider. This streamlined execution allows us to plan more effectively and efficiently for our clients.

Substantive Powers

Finally, the new law makes minor, but consequential changes to powers related to health care and continued gifting in the statutory short form. The principal's designated authority is expanded to include "financial matters related to health care," rather than "health care billing and payment matters." Gifting is also amended to allow the agent to continue the principal's customary gifts to individuals or charities for up to $5,000 total, rather than the prior $500. These changes expand the agent's powers to accomplish the principal's direction and wishes, particularly as these directions continue what the principal did or meant to do prior to incapacity.

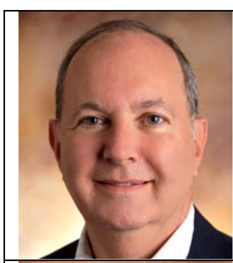
Planning Opportunities

Planning for potential incapacity remains important in 2021 with increasing hospitalizations and quarantining because of the coronavirus. More businesses and schools are anticipated to re-open, even prior to the full distribution of a vaccine. Therefore, many individuals may continue to be exposed to the virus and its potentially debilitating symptoms. The changes in the New York POA law allow people to communicate their directions more effectively and efficiently, and help third parties rely on these POA with more certainty and clarity. These changes also provide a model for other states considering similar statutes to support its residents and planners.

Given the opportunity to plan, people may want to review the following:

- Have you moved states with an intention to stay? If so, should you consider executing a Power of Attorney under this state's laws?
- Who is your agent? Can he or she still serve? Do you still want them to serve?
- What authorit(ies) does your agent have to act? What other authorities might you want to give your agent?
- Will you consider re-executing a New York Power of Attorney prior to June 13, 2021 under the prior law, or after under the new law?

The new law passed in December 2020 marks the most substantial update to the New York Power of Attorney law in almost a decade. These changes are necessary to ensure all New York residents have access to proper planning and can rely upon third-party's future acceptance of these valid documents. Familiarizing yourself with your current POA, or discussing your options with an attorney, may give you more power and the clarity in a continued, uncertain environment.

	Alan D. Kroll is a partner at Davis & Gilbert, LLP in the Private Clients Services Practice Group in New York, N.Y.
	Brian M. Balduzzi is an associate at Davis & Gilbert, LLP in the Private Client Services Practice Group in New York, N.Y.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2838

Date:	**17-Nov-20**
From:	**Steve Leimberg's Estate Planning Newsletter**
Subject:	**Evan Levine & Nainesh Shah on Estate of Aaron U. Jones: Key Business Valuation Issues Addressed by Tax Court**

Business valuation rules and norms frequently evolve as a consequence of IRS and Tax Court rulings. Every few years, a case comes along in which the judgment has an immense influence on the valuation field, and the Estate of Aaron U. Jones is one of those cases. In its ruling, the tax court clarified its views on the treatment of business cross-ownership, the tax-effect of s-corporations, the right valuation approach for an asset-heavy business, the validity of revising financial, and other valuation-related issues.

Evan Levine and **Nainesh Shah** provide members with their analysis of *Estate of Aaron U. Jones*.

Evan Levine is a Chartered Financial Consultant with over 30 years of experience. He has given dozens of educational seminars on retirement and estate planning. His articles have appeared in the CPA Journal, The National Public Accountant, and Advisor Today.

Nainesh Shah is a Chartered Financial Analyst with over 25 years of experience. He is a member of the CFA Institute and has presented to over 100 audiences of financial advisors and non-profits on macroeconomic conditions, capital markets, portfolio construction and risk management.

Here is their commentary:

EXECUTIVE SUMMARY:

Business valuation rules and norms frequently evolve as a consequence of IRS and Tax Court rulings. Every few years, a case comes along in which the judgment has an immense influence on the valuation field, and the *Estate of Aaron U. Jones* is one of those cases. In its ruling, the tax court clarified its views on the treatment of business cross-ownership, the tax-effect of s-corporations, the right valuation approach for an asset-heavy business, the validity of revising financial, and other valuation-related issues.

FACTS:

Let us begin with some background. The IRS filed a multi-issue case in the United States Tax Court against Aaron U. Jones about the taxes paid on gifts to his three daughters. These gifts came from his ownership in his two S-corporations, Seneca Sawmill Company (SSC) and Seneca Jones Timber Company (SJTC). The IRS disputed that the business appraisal was too low, the difference between the IRS estimate and Aaron Jones' estimate being about $89 million. As a result, the IRS demanded taxes of about $45 million.

Aaron Jones owned SSC, a sawmill company, and SJTC, a timber wood company. One issue of this case was that these companies were functionally one business, as SSC owned 10% of SJTC. Both companies shared a headquarters, key employees and executives, as well as co-signed loans. Additionally, SJTC only sold timber to SSC. In fact, SJTC could not have operated independently of SSC, and Aaron Jones had no intention of selling the SJTC business. These facts proved that the companies were cross-owned and that the cross-ownership was not only legal but also functional. Still, the IRS wanted to value them separately.

The court, yet, sided in favor of the private valuator, who appraised the companies as one interrelated entity. Using the most current financial data, the analyst valued the gifted part of Jones' estate at $21 million, instead of the $120 million the IRS had estimated.

Another key issue in this case, was about the pass-through entity and how it is tax affected. Tax-affecting is not a new issue; there has been an ongoing debate about tax-affecting in the valuation field for many years. While a real-world practitioner knows that the buyer always thinks about the tax effect, the court had not spoken on this issue for over twenty years. In Jones's case, the Tax Court sided with the expert, saying the tax-affecting makes the most sense. Do these lead us to the right approach to value a sawmill & timber company, which are an asset-heavy business?

There are three main approaches that IRS revenue ruling 59-60 suggests the valuator should use: income, market, and asset. Usually, however, one approach makes the most sense for a particular business or industry. In the case of SSC and SJTC, the IRS applied an asset approach, which is how timber usually gets valued. Contrarily, the private valuator used an income approach because the sawmill and timber company were so inter-linked, a decision with which the court sided. Not only did the use of these different approaches lead to a lower estimate, but the economic recession also had a notable impact on it.

Due to the recession, the estate re-did the financial forecasting, which had been done three months prior. The IRS, however, chose to use the old forecast. The private valuator argued against this choice as re-forecasting was necessary due to changing economic circumstances, and the court sided with him. This court ruling is particularly relevant in the climate of the COVID-19 pandemic, where many industries have seen grave aftermath. If you are appraising a business, it is prudent to have the most recent income forecast to reflect market reality.

The court also decided on the marketability discount (DLOM), which can also impact the valuation. In this case, there was a considerable difference between the IRS and experts DLOM, being 35% and 30% respectively. Siding with the appraisers estimate indicated that the court viewed the valuator's documents as better justification for their DLOM number. The analyst must adequately document and support reports to have their value accepted in the court.

COMMENT:

From a practitioner's perspective, Estate of Jones is a critical case as it validated the valuator's approach and method of valuation. The valuator's correct representation of the company's structure and its impact on the value was crucial in the court's judgment. This case clearly demonstrates that analysts must make sure their valuation report and supporting documents support the conclusion. In the end, the court's judgment favored a more practical approach supported by more current data over the IRSs theoretical approach that used older forecasts and failed to account for changing economic conditions.

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

Evan Levine
Nainesh Shah

CITE AS:

Steve Leimberg's Charitable Planning
Email Newsletter Archive Message #303

Date:30-Nov-20

Subject: Larry Katzenstein - New Actuarial Tables Are Coming

"On August 7, 2020, the National Center for Health Statistics at the Centers for Disease Control and Prevention issued the decennial life table for 2009-2011. And why, you may ask, would anyone except nerds like me care? Because this is the source for the IRS actuarial tables which Code section 7520 mandates estate planners use to value life estates, unitrust interests, remainders, and annuities.

The tables are required by section 7520 to be updated every 10 years and this has happened since the enactment of section 7520 in 1989 on May 1, 1989, 1999, and 2009 but not on May 1, 2019. Because the CDC had not yet issued the decennial table the IRS couldn't move forward. Now that this data has been released, I would expect the IRS to issue its updated actuarial tables in the form of proposed regulations shortly, hopefully by the end of the year."

Larry Katzenstein provides members with commentary that reviews the new actuarial tables that should be issued soon by the IRS now that the National Center for Health Statistics at the Centers for Disease Control and Prevention issued the decennial life table for 2009-2011.

Lawrence P. Katzenstein is a nationally known authority on estate planning and planned giving. He practices in St. Louis, Missouri in **Thompson Coburn LLP**'s private client services area and is a frequent speaker around the country to professional groups. He received his undergraduate degree from Washington University in St. Louis and earned his law degree at Harvard Law School. He appears annually on several American Law Institute estate planning programs and has spoken at many other national tax institutes, including the Notre Dame Tax Institute, the University of Miami Heckerling Estate Planning Institute and the Southern Federal Tax Institute. Larry has served as an adjunct professor at the Washington University School of Law where he has taught both estate and gift taxation and fiduciary income taxation. A former chair of the American Bar Association Tax Section Fiduciary Income Tax Committee, he is also a fellow of the American College of Trust and Estate Counsel and a member of its Charitable Planning Committee, and has served as a member of the advisory board of the New York University National Center on Philanthropy and the Law. He is listed in The Best Lawyers in America® in the field of Trusts and Estates. Larry was named the St. Louis Non-Profit/Charities Lawyer of the Year in 2011 and 2015 and the St. Louis Trusts and Estates Lawyer of the Year in 2010 and 2013 by Best Lawyers®. He was nationally ranked in the 2009-2019 editions of Chambers USA for Wealth Management. Larry is also the creator of Tiger Tables actuarial software, which is widely used by tax lawyers and accountants nationwide.

Here is his commentary:

EXECUTIVE SUMMARY:

On August 7, 2020, the National Center for Health Statistics at the Centers for Disease Control and Prevention issued the decennial life table for 2009-2011. And why, you may ask, would anyone except nerds like me care? Because this is the source for the IRS actuarial tables which Code section 7520 mandates estate planners use to value life estates, unitrust interests, remainders, and annuities.

The tables are required by section 7520 to be updated every 10 years and this has happened since the enactment of section 7520 in 1989 on May 1, 1989, 1999, and 2009 but not on May 1, 2019. Because the CDC had not yet issued the decennial table the IRS couldn't move forward. Now that this data has been released, I would expect the IRS to issue its updated actuarial tables in the form of proposed regulations shortly, hopefully by the end of the year.

COMMENT:

What is the decennial table? The table is a distillation of the entire U.S. population, on a unisex basis and derived from the 2010 census, of the number of persons living at each age from 0 to 110. That single Lx table is the basis of every single mortality-based actuarial calculation we estate planners generally use. It is used for only one thing—to calculate the probability of surviving from one age to another age—but that is what underlies every actuarial calculation involving a life or lives.

How does the current table compare to the new decennial table?

Age	Lx old table	Lx new table	Gain
0	100000	100,000	0
1	99305	99,382	77
2	99255	99,341	86
3	99222	99,314	92
4	99197	99,293	96
5	99176	99,276	100
6	99158	99,262	104
7	99140	99,248	108
8	99124	99,237	113
9	99110	99,226	116
10	99097	99,217	120
11	99085	99,209	124
12	99073	99,200	127
13	99057	99,188	131
14	99033	99,171	138
15	98998	99,145	147
16	98950	99,112	162
17	98891	99,071	180
18	98822	99,022	200
19	98745	98,964	219
20	98664	98,899	235
21	98577	98,824	247
22	98485	98,741	256
23	98390	98,652	262
24	98295	98,560	265
25	98202	98,467	265
26	98111	98,374	263
27	98022	98,280	258
28	97934	98,186	252
29	97844	98,089	245
30	97750	97,990	240
31	97652	97,887	235
32	97549	97,782	233
33	97441	97,672	231

34	97324	97,559	235
35	97199	97,443	244
36	97065	97,321	256
37	96921	97,194	273
38	96767	97,059	292
39	96600	96,915	315
40	96419	96,761	342
41	96223	96,596	373
42	96010	96,416	406
43	95782	96,221	439
44	95535	96,005	470
45	95268	95,769	501
46	94981	95,510	529
47	94670	95,229	559
48	94335	94,923	588
49	93975	94,590	615
50	93591	94,226	635
51	93180	93,828	648
52	92741	93,398	657
53	92270	92,935	665
54	91762	92,438	676
55	91211	91,908	697
56	90607	91,342	735
57	89947	90,737	790
58	89225	90,091	866
59	88441	89,401	960
60	87595	88,666	1,071
61	86681	87,884	1,203
62	85691	87,052	1,361
63	84620	86,168	1,548
64	83465	85,227	1,762
65	82224	84,222	1,998
66	80916	83,142	2,226
67	79530	81,978	2,448
68	78054	80,729	2,675
69	76478	79,388	2,910
70	74794	77,958	3,164
71	73001	76,430	3,429
72	71092	74,798	3,706
73	69056	73,049	3,993

74	66882	71,178	4,296
75	64561	69,175	4,614
76	62091	67,045	4,954
77	59476	64,774	5,298
78	56721	62,366	5,645
79	53833	59,796	5,963
80	50819	57,081	6,262
81	47694	54,214	6,520
82	44475	51,205	6,730
83	41181	48,060	6,879
84	37837	44,809	6,972
85	34471	41,400	6,929
86	31114	37,895	6,781
87	27799	34,314	6,515
88	24564	30,701	6,137
89	21443	27,107	5,664
90	18472	23,587	5,115
91	15685	20,198	4,513
92	13111	16,996	3,885
93	10773	14,032	3,259
94	8690	11,348	2,658
95	6871	8,976	2,105
96	5315	6,932	1,617
97	4016	5,218	1,202
98	2959	3,824	865
99	2122	2,723	601
100	1477	1,882	405
101	997	1,261	264
102	650	818	168
103	410	514	104
104	248	312	64
105	144	183	39
106	81	104	23
107	43	57	14
108	22	30	8
109	11	15	4
110	0	0	0

The table, which of course is already 10 years out of date, shows remarkable improvements in longevity. Take a look at age 84:

Age	Old Lx table	New Lx table	Gain
84	37837	44,809	6,972

Almost 7000 more people out of 100,000 still survive at age 84 than under the old table. The improvements in longevity at older ages is truly remarkable. For example, the probability of survival from age 60 to age 90 went from 21.088% to 26.6021% in just ten years. No wonder the Today show stopped years ago highlighting viewers who attained age 100. There were just too many of them.

Note that the IRS could make small tweaks to the CDC Lx table but I would expect any tweaks to be minor and this gives us at least a good idea of the effect the new tables will eventually have. Obviously, once the new tables are effective the value of a life estate will be greater and the value of a remainder after a life less under the new assumptions. Assuming a 5% section 7520 rate, the life estate factor for a person age 60 jumps from .60739 to .63394.

Longer life expectancies will be advantageous in some cases and disadvantageous in others. A longer life expectancy can be advantageous if the value being measured is a lead interest for life (or the shorter of life or a term) in a charitable lead trust. But the deduction for a contribution to a charitable remainder trust for a life or lives will be smaller.

For example, the deduction for a $100,000 contribution by a 70 year old donor to a charitable remainder unitrust paying a 5% unitrust interest quarterly will fall from $51,981 to $49,111. There will be other effects as well. It will become even harder to get a CRAT to qualify for the 10% remainder value test and the 5% exhaustion test. Also reduced, of course, will be the charitable deduction for the remainder in a personal residence after a retained life estate.

Questions remain. Will we be allowed to elect to use the new rates for any transaction after April 30, 2019, the date on which the new tables were mandated by section 7520 to be effective? Will there be an effective date transition period? Will the IRS at some point allow use of exact computer-generated factors rather than the almost-exact published factors—almost exact because of rounding and related issues required to make published tables workable? Will the IRS make minor tweaks to the Lx table above?

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

Larry Katzenstein

CITE AS:

LISI Charitable Planning Newsletter #303 (November 30, 2020) at http://www.leimbergservices.com

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2833

Date:	**26-Oct-20**
From:	**Steve Leimberg's Estate Planning Newsletter**
Subject:	**Steve Oshins Releases 9th Annual Dynasty Trust State Rankings Chart**

□*The 9th Annual Dynasty Trust State Rankings Chart factors in the new era of Dynasty Trusts. This Chart is an easy-to-use summary of leading Dynasty Trust states that shows the material differences among the states and ranks them according to usability and flexibility. Planners often focus on the multi-generational estate tax benefits of a Dynasty Trust.*

This newsletter describes a number of additional benefits that can be obtained with a Dynasty Trust, some of which often go unnoticed and are therefore undervalued by planners. This includes creditor and divorce protection, federal and state income tax shifting, state income tax avoidance, income tax basis planning and avoidance of the widow□s election.□

Frequent **LISI** contributor **Steve Oshins, Esq., AEP (Distinguished)** authors three different annual state rankings charts and one state income tax chart:

- The Annual Domestic Asset Protection Trust State Rankings Chart
- The Annual Dynasty Trust State Rankings Chart
- The Annual Trust Decanting State Rankings Chart
- The Annual Non-Grantor Trust State Income Tax Chart

Steve recently updated and released his 9th Annual Dynasty Trust State Rankings Chart.

Steven J. Oshins, Esq., AEP (Distinguished) is a member of the Law Offices of Oshins & Associates, LLC in Las Vegas, Nevada. He was inducted into the NAEPC Estate Planning Hall of Fame® in 2011. He was named one of the 24 □Elite Estate Planning Attorneys□ and the □Top Estate Planning Attorney of 2018□ by *The Wealth Advisor*. Steve was also named one of the Top 100 Attorneys in *Worth* and is listed in *The Best Lawyers in America®* which also named him the Las Vegas Trusts and Estates/Tax Law Lawyer of the Year in 2012, 2015, 2016, 2018 and 2020. He can be reached at 702-341-6000, ext. 2 or soshins@oshins.com. His law firm□s website is www.oshins.com.

Now, here is Steve□s commentary:

EXECUTIVE SUMMARY:

The Tax Cuts and Jobs Act of 2017 essentially doubled the federal estate and gift tax exemption which, after inflationary increases, is now $11.58 million per person, or $23.16 million per married couple. Therefore, very few people are subject to a federal estate tax. This exemption is increasing each year by an inflationary factor, but is scheduled to be cut back in half in 2026.

COMMENT:

I. Planning Opportunities

Historically, the avoidance of estate taxes was generally considered the most important reason to use Dynasty Trusts. However, with the federal estate tax exemption currently at $11.58 million, so many families are no longer subject to the tax that there are other features that are more important for many of our clients.

Creditor and Divorce Protection. Creditor protection and divorce protection might be the most compelling reason to use Dynasty Trusts. Very simply, outright transfers are subject to the claims of the creditors and divorcing spouses of the recipients of the transferred assets. That is generally not true of transfers in Dynasty Trusts, provided said trusts are properly drafted and/or sitused in a protective jurisdiction.

Federal and State Income Tax Shifting. Income shifting is also very important. This is true both for federal income tax purposes and for state income tax purposes. An outright transfer to an individual causes all income earned by the transferred assets and capital gains incurred as a result of sales of those assets to be taxed at the individual's federal and state income tax rates, whereas a well-drafted trust will allow the trustee to sprinkle the income to taxpayers in lower tax brackets.

State Income Tax Avoidance. Also, depending upon any state income tax long-arm statutes that may apply, there is often an opportunity to avoid incurring state income taxes by simply accumulating the income in a trust rather than distributing unwanted income to a beneficiary who resides in a state with a state income tax who doesn't need or want the income. This opportunity was highlighted in the recent Kaestner decision which drew national attention. Suddenly, possibly as a result of that decision, state income tax avoidance using non-grantor trusts became one of the hottest areas of practice. This planning is further magnified by the $10,000 State & Local Tax Deduction limitations added via the 2017 Tax Act. The new inability to deduct state income taxes against federal income tax has substantially increased the tax savings for those who choose to do this planning.

Income Tax Basis Planning. Passing assets in trust rather than outright allows an independent trustee or trust protector to give a beneficiary a formula general power of appointment at death over assets with an income tax basis lower than fair market value, but not over assets with an income tax basis higher than fair market value. Compare this with the common situation where a Dynasty Trust isn't used and instead the transfers are made outright so that all assets get a new income tax basis at the beneficiary's death, including assets that will receive a step-down in income tax basis.

Avoidance of the Widow's Election. If inherited assets are distributed outright to the beneficiary, then at the beneficiary's death those assets are included in the Widow's Election calculation for a decedent living in a common law jurisdiction, as opposed to a community property jurisdiction. For those beneficiaries who were trying to minimize their spouse's inheritance, this can result in a very big difference in that the widow can take a percentage of these assets by electing to take against the will of the decedent.

II. The Chart

The 9th Annual Dynasty Trust State Rankings Chart ranks the top 12 Dynasty Trust states. Although there are a handful of states that would be ranked relatively close to the 12th state, it is so unlikely that an estate planner would select a state that ranks outside of the first tiers of Dynasty Trust states that the Chart ends at 12.
The top four Dynasty Trust states, based on the factors in the Chart, are: 1. South Dakota (99.5 points), 2. Nevada (98.5 points), 3. Tennessee (95 points) and 4. Alaska (93.5 points). There is a drop-off after these four states. There appears to be a Tier One made up of the first four states, followed by a Tier Two made up of the next seven states which have nearly identical points ranging from 83.5 to 88. This essentially means that slightly different weights could completely change the order of the Tier Two states, so the reader should take this to mean that they are all nearly in a seven-way tie.

III. Conclusion

Dynasty Trusts are no longer primarily focused on estate tax savings. The Tax Cuts and Jobs Act of 2017 has changed much of the emphasis on federal estate tax planning.

The 9th Annual Dynasty Trust State Rankings Chart factors in the new era of Dynasty Trusts. This Chart is an easy-to-use summary of leading Dynasty Trust states that shows the material differences among the states and ranks them according to usability and flexibility. Planners often focus on the multi-generational estate tax benefits of a Dynasty Trust.

This newsletter describes a number of additional benefits that can be obtained with a Dynasty Trust, some of which often go unnoticed and are therefore undervalued by planners. This includes creditor and divorce protection, federal and state income tax shifting, state income tax avoidance, income tax basis planning and avoidance of the widow□s election.

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

Steve Oshins

CITE AS:

9th Annual Dynasty Trust State Rankings Chart

Rank	State	Perpetuities Statute	Rule Against Perpetuities (40% weight)	State Income Tax (25% weight)	Third-Party Spendthrift Trust Provision Effective Against Divorcing Spouse/Child Support (Divorcing Spouse – 7.5% weight/Child Support – 2.5% weight)	Discretionary Trust Protected from Divorcing Spouse/Child Support (2.5% weight)	Domestic Asset Protection Trust State Ranking (10% weight)	Trust Decanting State Ranking (10% weight)	Non-Judicial Settlement Agreement Statute (2.5% weight)	Total Score
1	SD	SD Codified L § 43-5-8	Perpetual	No	Protected	Protected	Ranked #2	Ranked #1	Yes	99.5
2	NV	NV Rev Stat § 111.1031	365 years	No	Protected	Protected	Ranked #1	Ranked #2	Yes	98.5
3	TN	TN Code § 66-1-202(f)	360 years	No (except dividends/ interest on residents)	Protected	Protected	Ranked #6 (tie)	Ranked #4	Yes	95
4	AK	AK Stat § 34.27.051	Perpetual/ 1,000 years if exercise power of appointment	No	Protected	Protected	Ranked #8	Ranked #8 (tie)	No	93.5
5 (tie)	RI	RI Gen L § 34-11-38	Perpetual	No (except residents)	Protected	Protected	Ranked #9	Ranked #14	No	88
5 (tie)	WY	WY Stat § 34-1-139	1,000 years	No	Divorcing spouse = Protected Child support = Not Protected (WY Stat § 4-10-503(b))	Protected	Ranked #12	Ranked #13	Yes	88
7 (tie)	DE	25 DE Code § 503	Perpetual for personal property/ 110 years for real estate	No (except residents)	Divorcing spouse = Not Protected Child support = Not Protected (Garretson v. Garretson (1973))	Protected	Ranked #6 (tie)	Ranked #3	Yes	86
7 (tie)	OH	Ohio Rev Code § 2131.09(B) and (C)	Perpetual/ 1,000 years if exercise power of appointment	No (except residents)	Divorcing spouse = Not Protected Child support = Not Protected (Ohio Rev Code § 5805.02(B)(1))	Protected	Ranked #3	Ranked #6	Yes	86
9	MO	MO Rev Stat § 456.025	Perpetual	No (except residents)	Divorcing spouse = Not Protected Child support = Not Protected (Mo. Rev. Stat. § 456.5-503(2))	Protected	Ranked #4	Ranked #7	Yes	85
10	NH	NH Rev Stat § 564:24	Perpetual	No (except dividends, interest on residents)	Divorcing spouse = Not Protected Child support = Not Protected (NH Rev Stat § 564-B:5-502)	Protected	Ranked #11	Ranked #5	Yes	84
11	IL	765 ILCS 305/3	Perpetual	No (except residents)	Divorcing spouse = Protected Child support = Not Protected (735 ILCS 5/2-1403 codifying *In re Matt* (1985))	Protected	None	Ranked #8 (tie)	Yes	83.5
12	FL	FL Stat § 689.225(2)(f)	360 years	No	Divorcing spouse = Not Protected Child support = Not Protected (FL. Stat § 736.0503(2)(a) codifying *Bacardi v. White* (1985))	Writ of garnishment allowed for spouse, former spouse, child support (FL Stat §736.0503(3); *Berlinger v. Casselberry* (2013))	None	Ranked #15	Yes	70

*The Domestic Asset Protection Trust State Ranking column is based on the 11th Annual Domestic Asset Protection Trust State Rankings Chart created in April 2020 at http://www.oshins.com/images/DAPT_Rankings.pdf.

*The Trust Decanting State Ranking column is based on the 7th Annual Trust Decanting State Rankings Chart created in January 2020 at http://www.oshins.com/images/Decanting_Rankings.pdf.

*This Dynasty Trust State Rankings Chart created in October 2020. Original Dynasty Trust State Rankings Chart created in October 2012.

Steve Oshins is a member of the Law Offices of Oshins & Associates, LLC in Las Vegas, Nevada. He was inducted into the NAEPC Estate Planning Hall of Fame® in 2011. He was named one of the 24 “Elite Estate Planning Attorneys” and the “Top Estate Planning Attorney of 2018” by *The Wealth Advisor* and one of the Top 100 Attorneys in *Worth*. He is listed in *The Best Lawyers in America®* which also named him Las Vegas Trusts and Estates/Tax Law Lawyer of the Year in 2012, 2015, 2016, 2018 and 2020. He can be reached at 702-341-6000, ext. 2 or soshins@oshins.com. His law firm’s website is www.oshins.com.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2836

Date: 12-Nov-20
From: Steve Leimberg's Estate Planning Newsletter
Subject: Mary Vandenack's Notes from the NYU Advanced Trusts and Estates Conference

The **NYU Advanced Trusts & Estates Conference** was held online on July 17, 2020. Mary E. Vandenack attended the NYU Advanced Trusts & Estates Conference, virtually, and agreed to share her notes.

Mary E. Vandenack is founding and managing member of **Vandenack Weaver LLC** in Omaha, Nebraska. Mary is a highly regarded practitioner in the areas of tax, benefits, private wealth planning, asset protection planning, executive compensation, equity fund development, business and business succession planning, tax dispute resolution, and tax-exempt entities. Mary□s practice serves businesses and business owners, executives, real estate developers and investors, health care providers, companies in the financial industry, and tax-exempt organizations. Mary is a member of the American Bar Association Real Property Trust and Estate Section where she serves as Co-Chair of the Futures Task Force, Co-Chair of the Law Practice Group and on the Planning Committee. Mary is a member of the American Bar Association Law Practice Division where she currently serves as Editor-in-Chief of Law Practice Magazine. Mary was named to ABA LTRC 2018 Distinguished Women of Legal Tech, received the James Keane Award for e-lawyering in 2015, and serves on ABA Standing Committee on Information and Technology Systems. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning topics as well as on practice management topics including improving the delivery of legal services, technology in the practice of law and process automation.

NOTES:

CHAIR:

Brad J. Richter

PLANNING ISSUES AND PROBLEMS WITH RESPECT TO DECANTING TRUSTS

Presenter: Wendy Wolff Herbert, Esq., Fox Rothschild, LLP, Princeton, NJ

Reasons for decanting include advancing tax goals, changing beneficial interests, changing trust situs, changing trustee provisions, changing administrative provisions, consolidating two or more trusts, dividing trust property, and addressing changed circumstances or errors.

Weidenmayer v. Johnson, 106 N.J. Super. 161 (App. Div. 1969). John Seward Johnson created a trust for his son, John Seward Johnson, Jr. The trustees exercised their discretion to distribute Seward□s interest to him and he contributed the distribution to another trust. Such trust provided for Johnson for life and for some of his children. Two children from a prior marriage were excluded. The children that were cut out sued. The court held the trustees had not abused their discretion.

Hodges v. Johnson, 170 N.H. 470 (2017). New Hampshire has a decanting statute allowing a trustee to decant from one irrevocable trust to another. A trust had been created by Settlor. Over the years, family rifts evolved. The Settlor requested the trustees to decant the trusts. The trustees did so and the result was to eliminate four of six beneficiaries and various contingent beneficiaries. The New Hampshire Supreme Court upheld a lower court ruling that the decanting was improper and void because the trustee violated his fiduciary duty.

Decanting statutes are based on common law. Fiduciary standards apply. Decanting authority exists in 30 states. Statutes vary in significant aspects regarding tax authority, fiduciary rules and notice requirements.

Regarding decanting statutes, consider who may decant, trustee authority, income rights and how they can be modified, who can be beneficiaries of new trust, standards of discretionary distributions that can be used in new trust, whether trustee can grant a power of appointment in the new trust, whether decanting power can be used to extend permissible perpetuities period, whether existence of outstanding withdrawal powers prohibit decanting, any limitations on decanting to maintain tax savings exemptions and characteristics, and whether notice of decanting must be given to beneficiaries.

<u>Tax Issues in Decanting</u>.

Decanting does not typically result in a recognition event; however a decanting of assets from one trust to another may result in a taxable exchange if beneficiaries possess interests in the new trust that are materially different and the transfer requires beneficiary approval.

<u>THE INTERSECTION OF DIVORCE AND TRUSTS & ESTATES: TOP TAX/PLANNING TIPS AND TRAPS</u>

Presenter: Sharon L. Klein, President, Family Wealth, Eastern Region

Significant changes to the treatment of trusts have occurred. IRC Section 682 was repealed as of January 1, 2019. This applies on the basis of the date the trust was created whether or not before January 1, 2019. The effect of Section 682 was to prevent a settlor from paying tax on income that was distributed to a former spouse. Practitioners have taken a variety of approaches to addressing the issue in trusts that are affected. For example, actions may be taken in some cases to remove the spouse beneficiary. Another approach is to distribute the trust assets. When drafting trusts in the planning stage, consideration should be given to the possibility of divorce.

Alimony payments are not deductible to payor or taxable to payee after December 31, 2018.

Pre-marital planning should consider the portability of the federal estate tax exemption. This is a valuable asset to be considered when a less wealthy spouse is marrying a moneyed spouse. The less wealthy spouse (assuming wealth is less than exemption) has a valuable asset in the form of the exemption.

Another premarital planning technique is the asset protection technique. For this technique to be effective, settlor must choose a jurisdiction that limits claims of spouse, former spouse, or minor child. Despite the specific laws, an asset protection trust provides protection in the form of making it more complicated to pursue trust assets. A spouse who marries a settlor after the trust is created is not included in the class of exception creditors.

Estate planning documents should be reviewed and updated in conjunction with divorce. Some states don□t allow for certain changes to estate planning documents during the pendency of a divorce; however, there are several documents that can and should be changed during the divorce. The updates that can be made should be made as soon as possible. Health care proxies and powers of attorney should be updated immediately to avoid having an about to be ex-spouse making decisions about COVD-19 treatments.

Divorce planning should consider a global asset perspective. Tax attributes of assets should be considered. Income and assets of divorcing clients should be considered via sophisticated analytics. Sophisticated analytics can improve negotiating leverage. Additionally, post-divorce, excellent financial planning is in order.

Credit and leverage can be useful in a divorce proceeding to assist one client buy the other out of various assets.

There is a trend including trust interests in divorce proceedings. If a trust is involved in a divorce, the trust terms matter; however, also look at the history of trust distributions. It will be more protective if there are multiple beneficiaries, a corporate trustee and the settlor of the trust is other than the divorcing spouse.

Trust decanting can be a useful tool in a divorcing situation. In *Ferri V. Powell-Ferri Holdings*, decanting was authorized. As a result, assets were placed out of reach of divorcing spouse. New trust is not a marital asset but could be considered in alimony.

Power to Adjust and Unitrust Regimes can be used to revise trust distributions.

Life Insurance plays an integral role in divorce. Insurance is often used to insure alimony or child support obligations. The pandemic has increased mortality risk. Be proactive to make sure insurance is performing if there is an investment component. Policy reviews should be conducted annually to review details. Details should include where premium notices are being mailed, beneficiary designation, ownership, and any tax issues related to the policy. Attorneys have been sued over life insurance policies not being titled properly.

States have different approaches to ownership and use of genetic material after divorce. States continue to vary as to the eligibility for inheritance of children born after the death of his or her genetic parent.

Personal exemption has been suspended.

Miscellaneous itemized deductions suspended.

USE OF CHARITABLE VEHICLES TO DEFER GAIN

Presenter: *Jerry Hesch*, Esq**.**, Adjunct Professor at Florida International University School of Law and Boston University School of Law, Miami, FL and Boston, MA

A key current estate planning concern is getting a step up in basis at death. Communicating sophisticated estate planning techniques in an understandable is very important.

Regarding using a charitable remainder trust to postpone reporting of a gain realized from the sale of a marketable security for cash, ask client whether they would rather invest after the transaction with ten million in cash or seven million in cash.

Senior establishes a CRUT and contributes public company stock valued at $10,000,000 with zero basis. A 14.691% unitrust interest for life is retained. Senior is entitled to an immediate $1,000,000 charitable income tax deduction. Illustration is that trustee sells stock after creation for $10,000,000 in cash, invest the cash and earns 5% interest and dividends. At the end of year one, Senior receives Distribution of $1,469,100. Section 664 applies to determine taxation of distribution. Tier 1 allocates $500,000 to trust accounting income. The remaining $969,100 is a distribution of trust principal and taxable as long term capital gain because there was no basis. The $1,000,000 charitable income tax deduction provides an immediate income tax benefit which can be used to offset the income for the year the CRUT is created and the next five years.

Clients don't get a charitable deduction for income tax purposes when they give at death. (There may be other charitable benefits.) A charitable annuity can result in a current income tax deduction for a donor. Example: Senior gives charity $1,000,000 in cash. Charity agrees to pay Senior $58,000 per year for the rest of Senior's life. Senior will have a charitable deduction of $323,384. Present value of $58,000 annually for a person age 70 is $676,616 (using 5.8% as annuity factor).

"THE BAKER'S DOZEN" – 13 TIPS THAT YOU SHOULD KNOW WHEN PREPARING A 706

Presenter: George D. Karibjanian, Esq., Partner, Franklin Karibjanian & Law, PLLC

5 Points to Preparing a 706

- Determine assets that are included and value.
- Compute tentative taxable estate.
- Compute tentative tax under unified rate schedule.
- Subtract the total amount of gift taxes paid.
- Subtract applicable credit, foreign death tax credit, credit for federal estate tax on prior transfers, and credit for gift tax on pre-1977 gifts included in estate.

Taxable gifts are not what you think it means! "Adjusted taxable gifts" are total "taxable gifts" made by decedent after 1976, other than gifts included in the gross estate. "Taxable gifts" are the total amount of gifts made each year, less exclusions (i.e., the annual exclusion as well as medical or educational exclusions and deductions for charitable and spousal gifts. What is missing from "adjusted taxable gifts" is the fact that the amount is not necessarily the total prior gifts as reported on 709.

Alternate Valuation generally occurs on the first of the date of the disposition of the asset or 6 months from the date of death or disposition of asset. Regarding jointly owned assets, see Treas. Reg. 20.2032-1(c).

Checking yes on Line 11a is likely to lead to an audit. The reason is the concern that there were discounts. 11b covers discount and is another box that may lead to audit.

Consider disclosing sale to grantor trust on a 709 return to start the statute of limitations. Line 13 e on 706 requires disclosure of sale to defective grantor trust. Audit could result years after the transaction.

An executed contract to purchase real estate is considered an interest in real property reportable on Schedule A. An executed contract to sell real property where title was not transferred before death is reported on Schedule C.

Recourse debt is reported on Schedule A. The full value of real property is reflected and unpaid portion of debt is deducted on Schedule K.

Promissory notes should be valued by appraiser. Discounts can be taken. See Treas. Reg. 20-2031-4. Value follows Rev. Rul. 67-276. Revisit discount and note value at alternate valuation date. It's possible that something like a pandemic occurred between date of death and alternate valuation date.

The rules for outstanding gift checks is different for non-charitable and charitable gifts. Non-charitable gift checks are included in gross estate if check has not cleared the account. Charitable gifts are deductible on decedent's final income tax return and not includable in the gross estate.

A post 1976 joint spousal interest is always 50-50. If joint tenancy is with someone other than spouse, there is a determination about who contributed to the asset. For pre-1977 joint spousal interests, contribution test applies.

Refund from joint income tax return is included based on proportion of refund that is from income of decedent.

Burial plot is not included in decedent estate. If the lot was one of 10, the one that was used for decedent is excluded.

Travel expenses of one person to and from burial site and stone setting are deductible. Travel for additional family members is not deductible. Expenses directly attributable to funeral service and burial are deductible.

Keep in mind that misrepresenting an entry creates an issue for preparers under Circular 230. If there is a grey area, create a memo, memorialize analysis and provide memo to client.

There are expenses occurred in the administration of an estate that related to non-probate assets that are deductible on Schedule L. This may include assets that pass by beneficiary designation or otherwise contractually.

Administration expenses are either estate transmission expenses or estate management expenses. Estate transmission expenses will reduce marital or charitable deduction if charged to the marital or charitable property. Estate management expenses will generally not reduce the deduction if deducted on the estate□s income tax return.

HIGHLIGHTS OF THE SECURE ACT

Presenter: Brad J. Richter, Fried, Frank, Harris, Shriver & Jacobson LLP

A significant amount of assets exist in the form of retirement assets. There are multiple sources of controlling laws: Internal Revenue Code, ERISA, DOL, PBGC, creditors rights issues.

SECURE ACT was passed as part of budget bill December 20, 2019.

Changes at plan level include escalated automatic enrollment cap and credit for the same; increased flexibility for safe harbor plans; credit increase to small employers establishing SEP, SIMPLE-IRA, or other plan; 529 expansion to apprenticeship programs and educational loan repayments, pooled employer plan; and allowing long term part time workers to participate in 401k.

There were also changes at individual level. The age limit for contributions was removed. There must still be earned income to make IRA, ROTH IRA or spousal IRA contributions. Back-Door ROTH IRAs are permitted. The age at which required minimum distributions increased to age 72. There are penalty free withdrawals for birth/adoption. Graduate non-tuition fellowship and stipends are treated as compensation for IRA purposes. Kiddie tax was re-established.

The ability to use a stretch IRA was eliminated by repeal of the life expectancy for a majority of beneficiaries. Life expectancy has been replaced with a ten-year distribution period. Eligible designated beneficiaries (for whom life expectancy can be used) include spouse, minor child of participant/owner, disabled/chronically ill beneficiaries and less than ten years younger beneficiaries. SECURE Act impacts see-through trusts. There remains some uncertainty on full impact.

IRAs are income in respect of decedent. The amounts are includible in decedent estate and taxable for income tax purposes to recipient upon withdrawal. In estate plan drafting, give attention to estate tax apportionment clause.

The general rule of income taxation is one of ordinary income upon receipt. If there is no constructive receipts, there is no current taxation without actual receipt. Taxation results upon assignment in satisfaction of pecuniary amount. Exceptions to income taxation include rollovers, return of basis, life insurance, ROTH IRA distributions.

In some cases, tax considerations should not be the driver. For example, if there is a concern about the ability of a beneficiary to manage finances, beneficiary protection may prevail over tax consequences. There are likely to be less retirement plan trusts after the SECURE Act but trusts do still provide better control.

After the SECURE Act, lifetime distribution rules are unchanged. If an account owner dies after required beginning date, the life expectancy distribution scheme for beneficiaries other than eligible designated beneficiaries. Modified life expectancy rules apply to eligible designated beneficiaries.

If an account owner dies before required beginning date, the rules depend on whether there is a designated beneficiary. If spouse is sole designated beneficiary, spouse can use spouse□s single life expectancy or rollover; however the ten-year rule applies to the successor beneficiary. If beneficiary is not spouse but is an eligible designated beneficiary, the life expectancy of eligible designated beneficiary can be used but ten-year rule applies to successor beneficiary. If spouse is not the designated beneficiary but another individual is a designated beneficiary, if beneficiary is eligible designated beneficiary, then life expectancy of such beneficiary can be used but ten-year rule applies to successor. If designated beneficiary is not an eligible designated beneficiary, ten-year rule applies. If there is not a designated beneficiary, five-year rule applies.

If an account owner dies after required beginning date, the rules depend on whether there is a designated beneficiary. If spouse is sole designated beneficiary, spouse can use the longer of spouse□s life expectancy or participant□s life expectancy (rollover is still usually the best approach). If beneficiary is not spouse but is an eligible designated beneficiary, the life expectancy of beneficiary can be used but ten-year rule applies to successor beneficiary. If beneficiary is not an eligible designated beneficiary, then ten-year rule applies. If there is not a designated beneficiary, distributions continue over life expectancy of account owner.

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

Mary Vandenack

CITE AS:

LISI Estate Planning Newsletter #2836 (November 12, 2020) at http://www.leimbergservices.com