Curing Estate Plans That No Longer Make Sense in Light of the American Taxpayer Relief Act

Tulsa Estate Planning Forum

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I. Introduction

A. In general

From time to time, clients want to escape from estate planning transactions they previously put in place. There are many reasons why a client might no longer need or want a particular transaction he or she previously embraced. Examples include a significant change in net worth, a marriage or divorce, death of a spouse, birth or death of children, and estrangement between the client and his family. This is nothing new, and estate planning lawyers have dealt with the remorseful client when the occasion demanded.[1]

B. The American Taxpayer Relief Act of 2012

The American Taxpayer Relief Act of 2012 ("ATRA") provides one more reason for many clients to revisit previous estate planning transactions. Recall that, fewer than fifteen years ago (in 2000):

- The basic exclusion amount was $675,000;
- The GST exemption was $1,030,000;
- The maximum estate and gift tax rate was 55% (with an additional 5% surtax on the value of certain large estates);
- The generation-skipping transfer tax rate was 55%; and
- The applicable exclusion amount not used by a spouse was lost and could not be used by the other spouse.

As a result of ATRA:

- The basic exclusion amount and the GST exemption are $5,430,000 in 2015, and will increase with inflation in future years;
- The maximum estate and gift tax rate is 40%;
- The generation-skipping transfer tax rate is 40%; and
- The basic exclusion amount not used by a spouse is "portable" and can be used by the other spouse.

The increases in the exclusion and exemption amounts have far outpaced the rate of inflation. Between January 2000 and January 2014, the consumer price index[2] increased by about 39%.[3] In contrast, the estate and gift tax exclusion increased by about 691%, and the GST exemption increased by about 418%. In the meantime, the maximum federal wealth transfer tax rate dropped by 27%.

In short, the federal wealth transfer tax system is no longer relevant to most taxpayers and less relevant to the rest. The IRS has indicated that the number of estate tax returns has declined 87% from about 73,100 in 2003 to about 9,400 in 2012. The congressional Joint Committee on Taxation has reported that only about 0.2 percent of estates of people who die pay estate tax, down from 2.16 percent in 2000 and 6.47 percent in 1973. A recent study by the Russell Sage Foundation reported that in 2013, the median American household had a net worth of $56,335, while households in the 95th percentile had a net worth of $1,364,834. Clearly, a very small percentage of taxpayers need to be concerned about transfer taxes.

But while the federal transfer tax burden has decreased, the federal income tax burden for many clients and trusts has increased. The maximum federal income tax rate is now 39.6%, and most affluent taxpayers will pay tax on long-term capital gains and dividends at a rate of 20% rather than 15%. Capital gains on collectibles is imposed at a rate of 28%. Effective January 1, 2012, the Health Care and Reconciliation Act of 2010 ("HCA") added a 3.8% surtax on net investment income. Therefore the most affluent taxpayers, including many trusts, could face marginal federal income tax rates of as high as 43.4% on ordinary income and 23.8% on long-term capital gains and dividends.

Even in states that have no state income tax (like Florida and Texas), after considering the 3.8% Medicare tax and the phase out of itemized deductions, the effective income tax rate on ordinary income and short-term capital gains can reach 44.59%. For those taxpayers who live in states having a state income tax, the burden is even greater. For example, the effective income tax rates on ordinary income and short-term capital gains can be as high as 52.26% in New York City, 52.02% in California, 50% in the District of Columbia, and 51.23% in Hawaii.

The effective tax rates on long-term capital gains incurring a federal rate of 20% can be as high as 24.99% in Texas, 37.69% in New York City, 37.29% in California, 33.94% in the District of Columbia, and 35.99% in Hawaii. For those capital gains taxed at a federal rate of 28% (*e.g.*, on collectibles), the effective rates can reach 32.99% in Texas, 45.69% in New York City, 45.29% in California, 41.94% in the District of Columbia, and 43.99% in Hawaii.[4]

There has always been a tension between reducing transfer tax and reducing income tax. Often, transactions or techniques designed to reduce transfer tax can result in increased income tax. An obvious example is the bypass or credit shelter trust. It may reduce transfer tax at the surviving spouse's death but at the cost of (i) forgoing a new income tax basis for appreciated assets and (ii) potential increased capital gain tax.

<u>Example</u>: *Existing bypass trust owns assets with a fair market value of $3 million and an income tax basis of $1 million. Surviving spouse dies in 2015, with a $2 million estate distributed to descendants. The bypass trust terminates with its assets distributed to descendants. Descendants receive $5 million of assets with a built-in taxable gain of $2 million. Since the combined value of the bypass trust and surviving spouse's estate is less than surviving spouse's $5.43 million basic exclusion amount, the bypass trust causes a*

loss of basis adjustment resulting in a $2 million built-in taxable gain for no estate tax benefits. In contrast, if all of the assets had been owned by surviving spouse, the descendants would have received $5 million of assets with no built-in gain.

ATRA and HCA create a new paradigm. We can no longer assume that removing an asset from the transfer tax base will result in overall tax savings. Rather, for most taxpayers it will be more important to plan for reducing income tax than for reducing transfer tax.

Like any tax law, ATRA is not immutable, and we may see reduced transfer tax exclusions or increased transfer tax rates in the future.[5] The Administration's proposed fiscal 2015 budget and the Treasury's explanation of the proposal (the "Green Book") recommend that we return to the 2009 estate, GST, and gift tax parameters with the top tax rate of 45% and exclusion amounts of $3,500,000 for estate and GST tax and $1,000,000 for gift tax. Congressman Dave Camp, Chairman of the House Ways and Means Committee, recently indicated that the House may vote to repeal the estate tax. In addition, future case law, regulations, and rulings may alter the tax landscape.

However, many of our clients, facing this new, post-ATRA tax landscape, may well conclude that an estate planning transaction put in place several years ago for the primary purpose of reducing transfer taxes no longer makes sense or, even if it does make sense, that there are more tax-effective ways to administer it. And this may be true even for those clients residing in states that impose state transfer taxes.

C. Overview of Materials

This paper focuses on existing planning transactions that no longer make sense in light of ATRA and addresses how we can help our clients escape from the no-longer-useful estate planning transaction or more efficiently administer those that they cannot escape from. We have organized the paper around strategies that ATRA has inspired – strategies whose goal is to respond to the new ATRA paradigm in which avoidance of estate tax often will take a back seat to other objectives. Specifically, we discuss the following nine strategies that clients may wish to pursue in the post-ATRA context:

- Avoiding valuation discounts for client-owned assets;
- Causing inclusion of trust assets in the settlor's[6] estate;
- Causing inclusion of trust assets in a beneficiary's estate;
- Causing inclusion of trust assets in a third party's estate;
- Causing inclusion of gifted assets (not in trust) in the donor's estate;
- Changing ownership of spousal assets to achieve a new income tax basis for appreciated assets and to preserve the income tax basis of "loss assets";

- Avoiding imposition of the 3.8% net investment income tax ("NIIT");
- Addressing life insurance policies and life insurance trusts that are no longer needed; and
- Turning off grantor trust status to avoid unnecessary wealth shifts and to facilitate income tax planning.

For each strategy, the paper discusses one or more estate planning techniques that clients may have implemented in the past but that, after ATRA, invite the use of that strategy to modify the client's estate plan. We then suggest specific actions the client can take to implement the strategy, and for each we discuss the following issues:

- Income taxes;
- Transfer taxes;
- Fiduciary duties;
- Administrative matters; and
- Claims of creditors and spouses.

D. Common issues

There are certain issues common to most or all of the strategies that this paper covers. Rather than address those issues individually with respect to each strategy, we deal with them globally here.

1. Planning for the future

This paper identifies estate planning transactions that our clients may have implemented in the past but that no longer make sense in light of ATRA, and it addresses how we can help our clients escape from these transactions or more efficiently administer those they cannot escape from. This paper does not address new estate planning strategies or structures that we should encourage our clients to use in light of ATRA.

2. Ethical issues

Unwinding or modifying existing estate planning transactions inevitably results in benefitting some people to the detriment of others. For example, a given transaction may benefit the grantor and harm the beneficiary, or benefit one spouse and harm the other, or benefit a parent and harm a child, or benefit a grantor and risk imposing liability on a trustee. In most cases, the conflicting interests will be obvious.

In each case, counsel must clearly identify the party he or she represents, disclaim any intent to represent any other party, and perhaps even suggest that other parties consult

their own counsel before taking action designed to unwind a previous estate planning transaction. The easiest way for counsel to run afoul of ethical obligations is to overlook the conflicting interests present in each case.[7]

3. State and local tax issues

To some extent, ATRA shifts the focus of estate planning from transfer taxes to income taxes. Deciding whether to unwind a prior estate planning transaction may ultimately involve balancing its estate tax benefit against its income tax cost.

The outcome of that balancing may depend upon where the client resides, where his property is located, the situs of a trust, and the residency of a trust's beneficiaries. It may yield one result for a Texas or Florida taxpayer, who faces no state transfer or income taxes, but another result for a New York City taxpayer, who faces both state and local transfer and income taxes, in addition to federal taxes.

This paper focuses almost exclusively on the federal tax system. It does not focus on specific state or local income or transfer taxes. Counsel with clients who reside or whose property is located in those states that have their own income or transfer taxes will need to take those taxes into account in deciding whether to unwind an existing transaction and in evaluating the results of doing so.

4. State law regarding fiduciary duties

Many of the solutions offered in this paper entail action by a trustee, which obviously raise issues regarding whether the solutions are consistent with fiduciary duties.

The comments regarding fiduciary duty issues in this paper are general. State law varies regarding not only the fiduciary duties of a trustee but also whether and to what extent an exculpatory provision in a trust instrument is valid and whether and how beneficiaries can absolve a trustee of liability for a breach. In discussing each potential solution, this paper does not attempt to analyze the fiduciary liability issues that may arise under the laws of each state.

Before recommending modification or unwinding of a transaction, counsel should consult local law to determine whether doing so could cause a trustee or other fiduciary to breach a fiduciary duty to the trust beneficiaries or to others.

5. Governing documents

Unique provisions in the governing documents will often impact the ability to exit or modify the transaction. Before recommending any strategy discussed in this paper, counsel should be certain that the governing documents permit implementation of that strategy.

E. Other resources

Others have written and spoken on many of the topics discussed in this paper and, where appropriate, we have referred to their work in the endnotes. Steve R. Akers, Senior Fiduciary Counsel with Bessemer Trust, has prepared several "musings" that summarize his observations on presentations given at various estate planning seminars and conferences. Those summaries are particularly rich sources of information about planning in the post-ATRA world.

F. Disclaimer

This paper is not intended to be, and should not be construed as constituting, the author's opinion with regard to any specific case or transaction or the author's legal or tax advice with respect to any specific case or transaction.

II. Avoiding valuation discounts for client-owned assets

A. When the strategy is useful

In general, property included in a decedent's gross estate is valued at its "fair market value" at the time of the decedent's death—that is, at "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[8] And in general, for income tax purposes the basis of property acquired from a decedent is its "fair market value" at the time of the decedent's death, and for this purpose the "fair market value" of property is its estate tax value.[9]

Many factors can influence an asset's fair market value. For example, the ownership of assets can be structured so that various features of its ownership justify applying a discount in determining its fair market value. Obvious examples are:

- If the decedent owns only a fractional interest in an asset (including a fractional interest arising by virtue of community property laws), a fractional interest discount may be appropriate to recognize the limitations imposed on an owner of only a portion of an asset.

- If the decedent owns an interest in an entity and that interest does not permit him to participate in or influence management of the entity, a lack of control discount may be justified to recognize the limitations on his control over the asset.

- If the decedent owns an interest in an asset that he cannot readily sell (*e.g.*, a limited partnership interest), a marketability discount may be appropriate to reflect the fact that he cannot easily convert the asset to cash.

The types of discounts discussed above can reduce the fair market value of an asset and thereby reduce the estate tax due at the owner's death. For that reason, in the pre-ATRA days, many clients created ownership structures designed to justify application of discounts. They knew that reducing the fair market value of the asset would reduce its income tax basis, which in turn would lead to greater capital gains taxes upon sale or reduced depreciation deductions. But in many cases, the estate tax benefits outweighed the income tax cost.

ATRA has changed the calculus. After ATRA, valuation discounts will still produce an income tax cost but, because of reduced rates and increased exclusions and exemptions, may not yield as much, or even any, estate tax benefit.

Example: Client owns a 25% interest in a family limited partnership ("FLP"). The fair market value of the 25% FLP interest (with discounts) is $2.5 million while a 25% direct interest in the FLP's underlying assets (without discounts) would be $4 million. The value of client's other assets is less than $1.43 million. Upon the client's death, the inclusion of the FLP's assets (without discounts) will not generate estate tax and will provide all of the client's assets with a basis adjustment. In contrast, if the client continues to own the discounted FLP interest until death, the beneficiaries will receive assets with a potential built-in gain of $1.5 million for no estate tax benefits.

One post-ATRA strategy is to avoid valuation discounts on assets in the client's gross estate, incurring little or no estate tax cost in exchange for greater income tax benefits.

B. Implementing the strategy

1. Redeem a high-basis discountable interest in an entity

Limited partnerships and limited liability companies have commonly been used to obtain valuation discounts and to achieve other non-tax benefits (*e.g.*, creditor protection, control of assets, etc.). However, in light of ATRA these entities may not save transfer taxes and may result in increased income taxes. One solution is to convert the discountable entity interest into non-discountable cash or other assets by having the entity redeem it.

Example: Many years ago, client created an FLP and gifted limited partnership ("LP") interests to children, at discounted values, in an effort to, among other goals, minimize estate tax upon client's death. Client retained a 30% LP interest that has a liquidation value of $3 million but a fair market value (with discounts) of $2 million. Client's income tax basis in the LP interest is $2.8 million. The value of client's other assets is less than $2.43 million.

If client owns the LP interest at death, the inclusion of the LP interest in client's gross estate at $2 million (with discounts) will result in a step-down in basis from $2.8 million to $2 million - resulting in increased income tax to client's beneficiaries (upon subsequent disposition of the LP interest) for no estate tax benefits. In addition, if the

entity makes (or has previously made) a Code section 754 election, there may be a step-down in basis with respect to 30% of the FLP's underlying assets.

If the FLP redeems client's LP interest during lifetime, client will receive $3 million of cash or other assets resulting in a current taxable gain of $200,000. However, upon client's death, his beneficiaries will receive $3 million of cash and other assets with an income tax basis of $3 million.

a. Income tax considerations

Generally, a partner recognizes gain on a distribution in liquidation of his partnership interest only to the extent that any money received (or deemed to be received, in the case of relief from liabilities) exceeds his basis in his partnership interest.[10] Unlike non-liquidating distributions, a partner may recognize loss on a liquidating distribution,[11] subject to potential disallowance if the partnership is owned by related parties.[12]

A partner who receives a distribution of property in liquidation of his partnership interest generally takes such property with a basis equal to his basis in the partnership interest.[13] If the partnership distributes multiple properties and money, the partner's outside basis is first reduced by the amount of money distributed. His remaining outside basis is next allocated to unrealized receivables and inventory items, and finally to other distributed properties.[14]

Generally, no gain or loss is recognized by a partnership on the liquidation of a partner's interest.

b. Transfer tax considerations

So long as the owner receives fair market value for his interest in the entity, the redemption should not have transfer tax consequences.[15] The redemption proceeds will substitute for the entity interest in the owner's gross estate. However, if the redeemed interest was valued under Code section 2701, redemption may be a taxable event that causes an increase in the owner's taxable gifts.[16]

c. Fiduciary duties

Partners or other co-owners of a business entity may have fiduciary duties to each other in addition to the contractual duties they have under the entity's organizational documents. If redemption would adversely affect other co-owners, counsel should consider whether the redemption would violate any fiduciary duties.

d. Administrative issues

The entity’s organizational documents or applicable state law may affect the ability of the entity to redeem an owner's interest or govern the procedures for redemption.

The parties may need to obtain an appraisal to support the redemption price. The redeemed owner should consider filing a gift tax return and reporting the transaction in order to trigger the statute of limitations. Note the reduced requirements for adequate disclosure of non-gift transactions.[17]

e. Creditor and marital issues

A redemption may remove from the owner's hands an asset that is not attractive to creditors or a divorcing spouse (*e.g.*, a limited partnership interest) and substitute for it an asset that is attractive (*e.g.*, cash). The remaining owners of the entity will continue to benefit from the additional protection from creditors' and spousal claims.

2. Liquidate entity with discountable interests

Another way to convert discountable entity interests into non-discountable assets is to liquidate the entity and distribute its assets to its partners or members.

<u>Example</u>: *Many years ago, client created an LLC and gifted/sold LLC interests to children, at discounted values, in an effort, among other goals, to minimize estate tax upon client's death. The LLC owns assets with a value of $10 million and an income tax basis of $4 million. Client retained a 30% LLC interest that has a liquidation value of $3 million but a fair market value (with discounts) of $2 million. Client's income tax basis in the LLC interest is $1 million. The value of client's other assets is less than $2.43 million.*

Children's 70% LLC interests have a combined liquidation value of $7 million and a combined income tax basis of $2.3 million.

If client owns the LLC interest at death, the inclusion of the LLC interest in client's gross estate at $2 million (with discounts) will result in a step-up in basis from $1 million to $2 million – even though client's pro-rata share of LLC assets has a value of $3 million.

If the LLC is liquidated during client's lifetime, client and children may receive the LLC's assets with little or no current income tax. Client will receive $3 million of cash or other assets. However, upon client's death, his beneficiaries will receive $3 million of liquidation proceeds with an income tax basis of $3 million.

a. Income tax considerations

The income tax consequences of the liquidation of a partnership to an individual are the same as a liquidation of an individual's interest.[18] That is, a partner (or member, in the case of an LLC) generally recognizes gain on the liquidating distribution only to the extent that any money received exceeds his basis in his partnership interest and may recognize loss.[19] A partner who receives a distribution of property in liquidation of his partnership interest generally takes such property with a basis equal to his basis in the partnership interest.[20] If a partnership distributes multiple properties and money, a

partner's outside basis is first reduced by the amount of money distributed. His remaining outside basis is next allocated to unrealized receivables and inventory items, and finally to other distributed properties.[21]

b. Transfer tax considerations

In general, so long as the assets of the entity are distributed to its co-owners in accordance with their respective interests, liquidation should have no gift tax consequences. The obvious estate tax consequence is to substitute an interest in the entity's assets for an interest in the entity in the owner's gross estate. However, if the liquidated interest was valued under Code section 2701, liquidation may be a taxable event that causes an increase in the owner's taxable gifts.[22]

c. Fiduciary duties

Persons in control of the entity may have fiduciary duties to non-controlling owners. If some non-controlling owners object to liquidating the entity, counsel should consider whether liquidation over some owners' objections would violate any of those duties. If one of the co-owners is a trust, the trustee will have fiduciary duties to the beneficiaries. The trustee must take those duties into account in deciding whether to agree to the liquidation.

d. Administrative issues

Limited partnerships and limited liability companies are sometimes complicated organizations, and administering them can be costly and burdensome (*e.g.*, additional income tax returns, accounting fees, segregation of assets, etc.). Liquidation solves those problems and provides simplicity. However, it also forfeits the benefits of holding assets in the entity (*e.g.*, creditor protection, family asset management, etc.)

e. Creditor and marital issues

Most states provide additional creditor protection with respect to a client's interests in a limited partnership or LLC.[23] Unwinding the entity may increase the ability of creditors to reach the assets.

In Texas, a divorcing spouse's separate property is protected, while a court may divide community property between the spouses. Therefore, preservation of separate property may be important to many clients. While appreciation in separate property remains separate property, distributions from a limited partnership (excluding liquidating distributions) are presumed to be community property. Therefore unwinding an entity may facilitate additional divorce protection for post-liquidation appreciation on separate property assets.

3. Purchase additional interests in entity to reduce or eliminate discounts

A third way of converting discountable entity interests to non-discountable assets is for the client to purchase interests in the entity held by others so as to eliminate the factors that cause discounts. For example, if Child is the general partner in a limited partnership and Parent is one of the limited partners, Parent could purchase Child's general partnership interest. If Parent is both a limited partner and the general partner, Parent's rights and powers as general partner may reduce discounts on Parent's limited partnership interest.

a. Income tax considerations

If the purchased interest is held by a grantor trust created by the client, there should be no income tax consequences. If the purchased interest is held by a non-grantor trust or another taxpayer, there will be a sale or exchange, and the seller may recognize gain or loss depending upon the identity of the parties, the seller's basis, and the purchase price.

b. Transfer tax considerations

In general, if the purchaser pays fair market value for the seller's interest, there should be no gift tax consequences. However, if the purchased interest was valued under Code section 2701, the purchase may be a taxable event that causes an increase in the seller's taxable gifts.[24]

c. Fiduciary duties

If other co-owners object to the transaction, consider whether it violates any fiduciary duties that co-owners owe to each other or that controlling owners owe to other owners. If one of the co-owners is a trust, the trustee will have fiduciary duties toward the beneficiaries, which he must take into account in deciding whether to engage in the transaction.

d. Administrative issues

The organizational documents of the entity may prevent an owner from selling his interest, grant options or rights of first refusal to other co-owners, or otherwise limit the ability of a co-owner to sell his interest.

The parties may need to obtain an appraisal to support the purchase price. The purchaser should consider filing a gift tax return and reporting the transaction in order to start the statute of limitations. Note the reduced requirements for adequate disclosure of non-gift transactions.[25]

e. Creditor and marital issues

If the client owns both a controlling interest (*e.g.*, a general partnership interest) and a non-controlling interest (*e.g.*, a limited partnership interest), the two combined may become more valuable and, therefore, may be more attractive to the client's creditors and a divorcing spouse. Many state statutes, however, provide that a charging order is a judgment creditor's sole and exclusive remedy against a judgment debtor's interest in an entity.[26] Importantly, a charging order only entitles the creditor to receive distributions from the entity if and when such distributions are made; it does not give the creditor the right to force distributions from the entity. Despite this, the true scope of a charging order's protection may be uncertain in select states, particularly when a control interest is involved.[27]

4. Convert entity with discountable interests into entity with no or limited discountable interests

A fourth way of converting discountable entity interests into non-discountable assets is for the owners to change the nature of the entity from one that has discountable features to one that does not. For example, the owners of a limited partnership could convert the entity to a general partnership with all limited partners becoming general partners. If either the partnership agreement or state law gives each general partner the right to manage the affairs of the partnership and to force a liquidation of the partnership, discounts applicable to valuing a partnership interest may be substantially reduced or eliminated.

a. Income tax considerations

Conversion of a limited partnership into a general partnership or LLC without restrictions that may justify a discounted value should not have income tax consequences.

b. Transfer tax considerations

Conversion of an entity from one form of business organization to another ordinarily will have no gift tax consequences if the parties' interests in the new entity are the same as their interests in the old entity. However, if the converted interest was valued under Code section 2701, conversion may be a taxable event that causes an increase in the owner's taxable gifts.[28] Query whether converting an LP interest into a GP interest could result in unintended gift tax consequences, particularly if the facts supported a preplanned transaction (*e.g.*, a gift or sale at a discounted value followed by a conversion)?

c. Fiduciary duties

Co-owners of a business entity have certain fiduciary duties to each other. If any owner objects to the conversion of the entity, consider whether the conversion violates any fiduciary duties owned to the objecting owner. If one of the co-owners is a trust, the

trustee will have fiduciary duties toward the beneficiaries, which he must take into account in deciding whether to engage in the conversion.

d. Administrative issues

The laws of each state will govern the conversion of business entities from one organizational form to another. Counsel will need to follow state law to ensure a successful change of entity form.

e. Creditor and marital issues

A general partnership interest or similar LLC interest is more attractive to creditors and to a divorcing spouse than is a limited partnership interest.

5. Amend entity documents to eliminate features that cause discounts

Another way of eliminating discounts to entity interests, like that of conversion to another form, is to leave the entity in place but amend its governing documents so as to eliminate those features that create discounts. For example, a limited partnership agreement might be amended to permit a limited partner to compel redemption of his interest at any time based on its net asset value rather than its fair market value.

a. Income tax considerations

Amending entity documents to eliminate features that cause discounts should have no income tax consequences.

b. Transfer tax considerations

If the amendment applies to all entity owners equally, there should be no gift tax consequences. However, in the context of a preplanned transaction, there could be unintended gift tax consequences.

c. Fiduciary duties

If some owners are able to amend the organizational documents over the objections of others, consider whether the amendment is consistent with the amending owners' fiduciary duties to the dissenting owners. If one of the co-owners is a trust, the trustee will have fiduciary duties toward the beneficiaries, which he must take into account in deciding whether to agree to the amendment.

d. Administrative issues

The entity's organizational documents will govern the procedures required to amend those documents. State law may also govern the amendment process.

e. Creditor and marital issues

The amendment may make the owner's interest more attractive to creditors or to a divorcing spouse.

6. Merge fractional interests in property that would otherwise be discounted

Some assets are discountable if the client owns only a fractional interest and co-ownership limits his freedom to deal with the asset. Examples include fractional interests in real estate, mineral interests, and tangible personal property such as art work. The discounts can be substantial, even when entities are not involved. For example, the Tax Court has approved discounts for fractional interests in timberland as high as 44% and 60%.[29]

An obvious way of eliminating fractional interest discounts is to eliminate the fractional interest. That is, the client could either purchase the interests held by other co-owners or sell his interest to them.

<u>Example</u>: *During a period of several years, client made annual exclusion gifts of fractional interests in a painting to a grantor trust for the benefit of descendants. The painting, which has a $2 million fair market value and a nominal income tax basis, is currently owned 60% by client and 40% by the trust. Upon the client's death, his gross estate will include the 60% interest in the painting valued at a discount, and the basis in the trust's 40% interest in the painting will not be adjusted.*

If the discount is not needed to avoid estate tax at the client's death, the client should consider one of the following actions:

1. Acquire the trust's 40% interest in the painting by purchase or swap. While the amount paid to the trust for the purchase or swap must reflect a fractional interest discount, the painting will pass to the client's children or their trust free of estate tax with a $2 million basis.

2. Sell or gift the balance of the painting to the grantor trust at a discounted value. Several years later, in an unrelated transaction, the client can reacquire the low basis painting free of income tax and without discounts with the objective of obtaining a basis adjustment equal to full fair market value at death.

<u>Example</u>: *Client and his 3 siblings inherited multiple parcels of farmland when their parent died 20 years ago. Upon client's death, the value of his ¼ interest in the parcels will reflect a fractional discount. If the discounted values are not needed to avoid estate tax, client and his siblings could enter into a Code section 1031 tax-free exchange, with each sibling receiving a 100% interest in separate parcels. Upon the client's death, his gross estate will include the parcels allocated to him, valued without any discounts, enabling his beneficiaries to sell those parcels free of income tax.*

a. Income tax considerations

The transfer should be free of income tax if it is between spouses or between a grantor and one or more grantor trusts, or if it qualifies under Code section 1031 (like-kind exchange). Otherwise, there may be gain or loss depending upon the identity of the parties, the seller's basis, and the purchase price.

b. Transfer tax considerations

If the transaction is between spouses, the marital deduction should preclude gift tax consequences regardless of the consideration paid to the seller. Otherwise, there should be no gift tax consequences if the purchaser pays fair market value for the fractional interest.

Note that this transaction may achieve the desired estate tax results (*i.e.*, elimination of a discount) only if the client acquires the fractional interests of others and the full interest is then held by the client. If the client sells his interest to other co-owners and, to avoid making a gift to the client, the other co-owners pay only fair market value, he will receive consideration equal only to the discounted value of his fractional interest. In other words, he will simply lock in the discount when he receives a purchase price that takes the discount into account.

c. Fiduciary duties

Spouses and other family members may owe fiduciary duties to each other to act fairly. If a trust is a party to the transaction, the trustee will need to ensure the transaction conforms with his fiduciary duties.

d. Administrative issues

If the transaction is not between spouses, the parties may need to obtain an appraisal to support the value of the acquired asset. The client should consider filing a gift tax return and reporting the transaction in order to trigger the statute of limitations. Note the reduced requirements for adequate disclosure of non-gift transactions.[30]

e. Creditor and marital issues

Regardless of whether the client is the purchaser or the seller, this transaction will convert an asset that is unattractive to creditors or divorcing spouses (*i.e.*, a fractional interest) into one that is more attractive (*i.e.*, full ownership of the asset in the case of a purchase, or cash in the case of a sale).

7. Transfer fractional interests in property that would otherwise be discounted to an entity or subject those fractional interests to a co-owners' agreement

Co-owners of an asset could contribute their respective fractional interests to an entity (such as a general partnership) in exchange for an interest in the entity. In the hands of the entity, the asset should no longer be discountable. If the entity's governing documents give each owner the right to force a sale of the asset at its undiscounted fair market value and to require distribution of the proceeds, discounts on the entity interests may be substantially reduced or eliminated.

The co-owners might achieve the same result by retaining their fractional interests in the asset but entering into a co-owners' agreement permitting any of them to sell the asset without joinder of the others so long as the consideration is distributed to the co-owners in accordance with their respective fractional interests.

a. Income tax considerations

Contributing an asset to an entity or entering into a co-owners' agreement should have no income tax consequences.

b. Transfer tax considerations

Contributing an asset to an entity or entering into a co-owners' agreement should have no transfer tax consequences.

c. Fiduciary duties

In general, so long as all co-owners agree, there should be no fiduciary duty concerns. However, if one of the co-owners is a trust, the trustee will owe fiduciary duties to the beneficiaries and should ensure that the transaction is consistent with those fiduciary duties.

d. Administrative issues

State law will govern the procedures for creating and funding an entity such as a general partnership and the permissible terms of the relationship between partners.

e. Creditor and marital issues

This technique involves transforming an asset that cannot easily be converted to cash into one that can more easily be converted to cash. As a result, the asset will be more attractive to the owners' creditors and to divorcing spouses unless they are precluded from exercising the liquidation rights.

III. Causing inclusion of trust assets in the settlor's estate

A. When the strategy is useful

Prior to ATRA, many clients transferred assets to irrevocable trusts in order to shift future appreciation to children or more remote descendants. Examples include both non-taxable transfers (*e.g.*, a transfer to a zeroed-out grantor retained annuity trust ("GRAT"); annual exclusion gifts to *Crummey* trusts; or an installment sale to a grantor trust) and taxable transfers (*e.g.*, to an irrevocable trust to consume some or all of the client's basic exclusion amount). Often clients made these transfers using limited partnership interests or other types of interests that were subject to valuation discounts, thereby leveraging the amount of wealth shift the transaction achieved.

As a result of ATRA, some clients may find that low basis, appreciated (and/or appreciating) assets are now held in irrevocable trusts where they will produce little or no estate tax benefit (due to the greater basic exclusion amount and reduced marginal tax rate) yet will incur an income tax cost through the loss of a basis step-up at the client's death. Those clients may find it attractive to recover the low-basis assets from the irrevocable trust in order to shift future appreciation from the trust to the client and to achieve a new income tax basis equal to fair market value at the client's death. Of course, the client should be sure that bringing assets back into his estate would not create estate tax liability when none would otherwise exist.

B. Implementing the strategy

1. Settlor exercises swap power with trust to recover low basis assets or assets with high appreciation potential

Many irrevocable trusts include a "swap power" that permits the grantor, acting in a non-fiduciary capacity, to reacquire the trust assets by substituting assets of equivalent value.[31] A swap power ensures that the trust is a grantor trust.[32] Practitioners often include swap powers in irrevocable trusts so that:

- The grantor can, in effect, make additional, tax-free transfers of wealth to the trust by paying the income tax due on the trust's income (discharging his own, but not the trust's, obligation);[33] and
- The grantor can engage in transactions (*e.g.*, purchases, sales, interest payments, etc.) with the trust without income tax consequences, because they are deemed to be transactions between the grantor and himself.

If the trust contains a swap power, the client can freeze the amount of the wealth shift at the current level and regain ownership of low basis assets by substituting cash or other assets of equivalent value for an asset held in the trust. This is particularly effective if the asset to be reacquired by the seller is valued at a discount for purposes of the equivalent value substitution and the seller recovers it from the purchasing trust before it realizes its

full value. If the reacquired asset is an interest in an entity that would otherwise be subject to a valuation discount at the client's death, he can consider engaging in one of the transactions described in Section II.B above in order to avoid the discount and receive a full basis adjustment at the client's death.

<u>Example</u>: *Client forms a limited partnership and funds it with income-producing assets with a net asset value of $1 million but an income tax basis of only $200,000. Client then sells a 99% LP interest to an existing irrevocable trust in exchange for a $600,000 installment note, which accounts for a 40% valuation discount. The trust is a grantor trust with respect to the client by reason of a swap power in the trust instrument.*

Following the sale, the trust uses the distributions it receives from the partnership (as owner of a 99% LP interest) to repay client on the installment note. Once the installment note is paid in full, all future partnership distributions are retained in the trust.

Assume the fair market value of the trust's 99% LP interest increases to $2 million following the trust's repayment of its installment note obligation. Subject to certain adjustments, the trust's income tax basis in its LP interest should be $200,000, which is the grantor's original income tax basis in the assets used to fund the partnership. If the trust owns the 99% LP interest at client's death, it would not receive a step-up in income tax basis at client's death. Based on client's balance sheet and current transfer tax laws, it would be more advantageous for the 99% LP interest (along with the partnership's assets) to be included in client's estate and eligible for a step-up in income tax basis at client's death.

If client has sufficient high basis assets, such as cash, client can swap $2 million cash for the 99% LP interest owned by the trust, which in this example has a $2 million fair market value. If client died owning the 99% LP interest, it would receive a step-up in income tax basis at client's death. Client could further harvest the step-up by eliminating any built-in valuation discount, either by unwinding the partnership or engaging in one of the transactions described in Section II.B above. Alternatively, if the installment note had not yet been repaid in full, the trust could distribute LP interests in-kind to satisfy any outstanding note payments.

a. Income tax considerations

Because the trust is a grantor trust, the swap will not have income tax consequences. For income tax purposes, the grantor will simply have exchanged assets with himself.

b. Transfer tax considerations

The client has a keen interest in ensuring that the assets he transfers to the trust are equal in value to those he receives. If he transfers too much to the trust, the IRS may contend that he has made an additional transfer to the trust, which may be a taxable gift. If he transfers too little to the trust, the IRS may argue that this evidences a retained interest in

the trust or that, in the case of a GRAT, the client received an excess distribution. Therefore, obtaining reliable valuation information is essential.

Using a defined value clause or a value adjustment clause may help avoid swapping a trust asset for another asset whose value is different, thereby mitigating the risk of an IRS challenge.

Assuming the client transfers assets to the trust having a value equal to those he receives, the swap should not have transfer tax consequences. The client need not report the swap on a gift tax return. However, he might consider doing so in order to trigger the statute of limitations.

c. Fiduciary duties

The trustee's fiduciary duty is limited when the grantor exercises a swap power. The trustee has no ability to prevent the grantor from swapping assets and, therefore, the trustee has no duty to try. However, the trustee does have a fiduciary duty to ensure that, if the grantor exercises his swap power, the assets he substitutes in the trust are equal in value to the asset he reacquired.[34] Also, if the grantor is reacquiring a limited partnership interest from the trust and the grantor is also the general partner of the limited partnership, consider whether the general partner has fiduciary duties to the limited partners (including the trust) that affect the swap transaction.

d. Administrative issues

As indicated above, it is crucial that the assets transferred to the trust and recovered from the trust have equivalent values at the time of the swap. If either or both of those assets does not have a readily ascertainable market value (*e.g.*, limited partnership interests, non-publicly traded stock, real estate, mineral interests, etc.), fixing the value may require an appraisal. This adds to the expense of the swap.

If the grantor does not wish to use existing assets (or does not have sufficient high-basis assets) to effectuate the swap, the grantor could consider exchanging a promissory note for the appreciating assets held in the trust. As long as the note bears interest at or above the AFR, the value of the note (for federal transfer tax purposes) should equal its face amount.[35] There is uncertainty regarding the income tax consequences of subsequent termination of grantor trust status while the note is outstanding. Does the grantor's death, terminating grantor trust status, trigger capital gains? What is the trust's basis in the promissory note upon termination of grantor trust status?

Alternatively, the settlor could borrow cash from a third party and use the borrowed funds for the swap. Upon the settlor's death, the swapped assets will receive a full income tax basis, and the loan can be repaid without the imposition of capital gains tax. The third party loan can be facilitated by the grantor trust providing a guarantee in exchange for a guarantee fee.

Consider using a defined value clause or an adjustment clause to ensure equivalency of values of the swapped assets. Also ensure that the parties comply with any requirements that an entity's organizational documents may impose for transfers of interests in the entity.

e. Creditor and marital issues

If the asset recovered from the trust does appreciate in value, the appreciation will be subject to spousal and creditor claims in the hands of the grantor. If the appreciation had remained in the trust it would not have been subject to claims against the grantor and it could have been protected against claims against the trust beneficiaries by a spendthrift provision. If the asset recovered is an interest in a FLP or LLC, state law may limit the creditor's ability to deal with the recovered interest and therefore make it less attractive to the creditor.

2. Settlor purchases assets from trust to recover low basis assets or assets with high appreciation potential (when there is no swap power but trust is still a grantor trust)

If the trust instrument does not include a swap power, the grantor can purchase the appreciating and/or low-basis asset from the trust at its current fair market value and thereby (i) shift post-transfer appreciation away from the trust beneficiaries and to the grantor, and (ii) obtain a new income tax basis for the asset at the grantor's death. This is especially effective if the purchased asset is subject to valuation discounts. The grantor can purchase the asset at a discounted price and then consider eliminating the discount by one of the methods discussed in Section II.B above. However, unlike the swap power solution, the grantor cannot unilaterally effectuate the purchase solution without the trustee's consent.

If a trust includes a swap power, it is automatically a grantor trust.[36] But if the trust does not include a swap power, it may or may not be a grantor trust depending upon the other trust terms. If a trust is not a grantor trust, consider converting it to a grantor trust by one of the following methods:

- Change trustees if, by doing so, grantor trust status would result under Code section 674;
- Lend trust funds to the grantor under circumstances described in Code section 675(3); or
- Seek judicial modification of the trust, or decant the trust into another trust, in order to create an interest or power that causes grantor trust status.[37]

a. Income tax considerations

Assuming the trust is a grantor trust, the swap will not have income tax consequences. For income tax purposes, the grantor will simply have exchanged assets with himself.

b. Transfer tax considerations

If the asset recovered from the trust does appreciate in value, the appreciation will be subject to spousal and creditor claims in the hands of the grantor. If the appreciation had remained in the trust it would not have been subject to claims against the grantor and it could have been protected against claims against the trust beneficiaries by a spendthrift provision. If the asset recovered is an interest in a FLP or LLC, state law may limit the creditor's ability to deal with the recovered interest and therefore make it less attractive to the creditor.

c. Fiduciary duties

Because the trustee has discretion as to whether to enter into a purchase and sale transaction with the grantor, the trustee must carefully consider whether the transaction is consistent with his fiduciary duties. For example, is the sale of the asset consistent with:

- The trustee's duty to act as a prudent investor;
- The trustee's duty of loyalty to the trust beneficiaries (including the remainder beneficiaries); and
- The trustee's duty to avoid self-dealing (if the grantor is the trustee, or if the trust agreement does not absolve the trustee of this duty)?

If it is unclear whether the transaction is consistent with the trustee's fiduciary duties, then consider:

- Does the trust instrument contain a valid exculpatory clause?
- Are the beneficiaries able and willing to exonerate the trustee from liability?

d. Administrative issues

See III.B.1.d above. Also, because of the trustee's fiduciary duties, the trustee will want to document his consideration of the proposed purchase and sale transaction and the reasons why the trustee considers the transaction to be in the best interest of all beneficiaries.

e. Creditor and marital issues

If the asset recovered from the trust does appreciate in value, the appreciation will be subject to spousal and creditor claims in the hands of the grantor. If the appreciation had remained in the trust it would not have been subject to claims against the grantor and it could have been protected against claims against the trust beneficiaries by a spendthrift provision. If the asset recovered is an interest in a FLP or LLC, state law may limit the creditor's ability to deal with the recovered interest and therefore make it less attractive to the creditor.

3. Grantor purchases remainder interest in a GRAT

A client may have an existing grantor retained annuity trust ("GRAT") that, in light of ATRA's $5.43 million basic exclusion amount, is no longer needed to shift additional assets in order to avoid estate tax. In addition, a client may desire to eliminate the administrative duties associated with a GRAT and to ensure that any future appreciation generated by the GRAT assets is shifted to him.

The Treasury regulations forbid commutation (*i.e.*, prepayment) of the grantor's annuity interest in a GRAT; however, they do not forbid the grantor from purchasing the remainder interest.[38] The typical spendthrift clause would prevent the remainder beneficiary from selling its beneficial interest to the grantor. However, if it does not, the grantor could purchase the remainder interest from the remainder beneficiary for its actuarial value. The grantor would then own the annuity interest and the remainder interest. This should cause a merger and a termination of the GRAT, putting the GRAT assets back into the hands of the grantor where estate tax is no longer an issue in light of ATRA and where the appreciated assets may receive a basis adjustment at the grantor's death. The remainder beneficiary will be left with cash or other high-basis assets equal to the value of the remainder interest at the time of the transaction, undiminished by estate tax at the grantor's death.

Example: Client created and funded a 10-year GRAT with $1 million in August 2011 when the IRC § 7520 rate was 2.2%. The GRAT was structured to pay client an annual annuity payment of $112,495 for 10 years. Client made a gift of only $1 upon creation of the GRAT since the annuity payments had a present value of almost $1 million. If client survives the 10-year term, any remaining assets will be distributed to a grantor remainder trust for the benefit of client's children.

Three years have passed, and the GRAT assets have realized significant appreciation. In fact, after payment of the first 3 annuity payments, the GRAT assets have a value of $1.25 million. Client is entitled to receive 7 more annuity payments of $112,495. The present value of the remaining 7 annuity payments is $722,502 (discounted at 2.2%, assuming this is the current Code section 7520 rate). Client believes that the assets will continue to have significant appreciation during the remaining 7 years of the GRAT term. However, in light of ATRA's significantly increased basic exclusion amount, client no longer needs to shift additional assets to avoid estate tax and client would like any future appreciation

to benefit him. Client and the remainder trust agree that client will purchase the remainder interest for its present value of $527,498 ($1,250,000 - $722,502). Since client will own both the annuity interest and the remainder interest, there should be a merger and termination of the GRAT, with client receiving all of the GRAT's assets.

If there are alternate contingent remainder beneficiaries (*e.g*., a trust for children if the grantor survives the GRAT term but a marital deduction trust if he does not), all potential remainder beneficiaries would need to sell their interests to the grantor. The purchase price for the entire remainder interest would be divided among the alternate remainder beneficiaries in accordance with the actuarial values of their respective interests.

This technique is often advocated for locking in a wealth shift achieved by a GRAT when there is concern that the grantor might die before the expiration of the GRAT term, which would result in most, if not all, of the GRAT assets being included in the grantor's estate. Here, the technique is advocated where reducing the grantor's estate is no longer needed due to ATRA and terminating the GRAT would (i) transfer future appreciation in the GRAT assets to the grantor rather than the remainder beneficiaries, (ii) provide the remainder beneficiaries with cash or high basis assets free of income tax; and (iii) permit the appreciated GRAT assets to receive a new income tax basis at the grantor's death.

a. Income tax considerations

If the remainder beneficiary is a grantor trust, this transaction should not have income tax consequences. If the remainder beneficiary is a non-grantor trust, consider whether it can be converted to a grantor trust by one of the methods described in Section III.B.2 above. If the remainder beneficiary is not a grantor trust and cannot be converted to one, the transaction will be a sale or exchange for income tax purposes. Property acquired by gift retains a "uniform basis," even if more than one beneficiary or class of beneficiaries acquires an interest in such property, as is the case when property is transferred to a GRAT and both an annuity interest and a remainder interest are created.[39] Upon the sale or other disposition of the remainder interest, a portion of this uniform basis is allocated to the remainder interest based on its actuarial value on the date of the sale.[40]

b. Transfer tax considerations

If the grantor pays fair market value for the remainder interest, there should be no gift tax consequences. Ensuring that the grantor pays fair market value may require an appraisal of hard-to-value GRAT assets. Consider using a defined value clause or a value adjustment clause to mitigate the risk of an IRS challenge. Perhaps report the transaction on the grantor's gift tax return to start the statute of limitations. Note the reduced requirements for adequate disclosure of non-gift transactions.[41]

c. Fiduciary duties

If the remainder beneficiary is a trust, the trustee will owe fiduciary duties to the trust beneficiaries. Because the trustee has discretion as to whether to enter into a purchase

and sale transaction with the grantor, the trustee must carefully consider whether the transaction is consistent with his fiduciary duties. For example, is the sale of the asset consistent with:

- The trustee's duty to act as a prudent investor;
- The trustee's duty of loyalty to the trust beneficiaries (including the remainder beneficiaries); and
- The trustee's duty to avoid self-dealing (if the grantor is the trustee, or if the trust agreement does not absolve the trustee of this duty)?

If it is unclear whether the transaction is consistent with the trustee's fiduciary duties, then consider:

- Does the trust instrument contain a valid exculpatory clause?
- Are the beneficiaries able and willing to exonerate the trustee from liability?

The trustee should be sure that the sale of the trust's remainder interest does not violate those duties.

d. Administrative issues

As indicated above, the transaction may require appraisal of the trust assets. Carefully calculate the amount that the grantor is required to pay to the remainder beneficiaries for their interests. Many practitioners use a computer program (e.g. NumberCruncher, Tiger Tables, z-Calc, etc.) to compute the amounts.

e. Creditor and marital issues

This solution presumes that the remainder interest is not subject to a spendthrift clause and is therefore subject to claims of the remainder beneficiary's creditors. This solution simply changes the assets that are subject to the creditors of the grantor and the remainder beneficiary, respectively.

4. Settlor, who previously created a domestic asset protection trust, moves the trust to a jurisdiction that doesn't provide creditor protection

The laws of some states (including, Nevada, South Dakota, Tennessee, Ohio, Hawaii, and Alaska) permit a settlor to create a trust for his own benefit and, through a spendthrift clause, prevent his creditors from reaching the trust assets in satisfaction of their claims.[42] The laws of other states do not recognize the validity of spendthrift clauses in self-settled trusts and permit the settlor's creditors to reach the settlors' assets contributed to such self-settled trusts.[43]

In the former group of states, the settlor may also avoid inclusion of the trust assets in his gross estate under Code section 2036(a)(1) if he names someone other than himself as trustee and gives the trustee complete discretion as to whether to distribute trust income and principal and in what amounts. If a non-settlor trustee has complete discretion over distributions, then arguably the settlor has not retained the possession or enjoyment of, or the right to the income from, the trust property.[44] In the latter group of states, the ability of the settlor's creditors to reach his interest in the trust results in inclusion under Code section 2036(a)(1), notwithstanding the trustee's discretion over distributions.[45]

Consider changing the situs of the trust for creditors' rights purposes to another state that exposes the settlor's interest to his creditors' claims. That should cause inclusion of the trust assets in the settlor's estate under Code section 2041. If the combined value of the settlor's assets and the trust's assets is less than the settlor's applicable exclusion amount, all such assets will receive a basis adjustment at the settlor's death without application of the estate tax.

a. Income tax considerations

There should be no federal income tax consequences. Presumably the trust was a grantor trust before the change of situs and it will be one thereafter. State income tax consequences will depend upon the laws of the trust's former situs and its new situs.

b. Transfer tax considerations

The settlor may have made a taxable gift when he created the self-settled trust. If so, that taxable gift should not count as an adjusted taxable gift for purpose of computing the estate tax on the settlor's estate.[46] Also, if the settlor paid any gift tax as a result of the gift to the self-settled trust, his estate may be entitled to a credit for that gift tax.[47]

c. Fiduciary duties

The trustee should be aware that, by exposing the trust assets to claims of the settlor's creditors, he may be inviting a claim that he breached his fiduciary duty to the beneficiaries if either (i) tax laws change and the change of situs results in imposition of estate tax, or (ii) the trust assets ultimately are lost or diminished by payments to the settlor's creditors. The prudent trustee will ask for releases and indemnities from not only the settlor but also all current and remainder beneficiaries.

d. Administrative issues

The trust instrument may describe the procedures necessary for a change of situs. Additionally, it may be necessary to change trustees in order to change the trust situs. If the trust instrument or the law of the current situs permits division of the trust into separate trusts, consider effecting such a division, funding one trust with appreciated assets but only in that amount necessary to fully use the client's applicable exclusion

amount, funding the other trust with high-basis or loss assets, and changing situs as to only the former trust.

e. Creditor and marital issues

Most importantly, employing this strategy will subject trust assets to claims of the settlor's creditors. Settlors in occupations that generate claims (*e.g.*, entrepreneur or surgeon) should carefully consider whether achieving a basis adjustment at death is worth putting the trust assets at risk.

5. Identify settlor's actions that may have triggered Code section 2036(a)(1)

Code section 2036(a)(1) provides that the client's gross estate will include any property he previously transferred for less than adequate and full consideration if the client "retained" the possession or enjoyment of, or the right to the income from, the property. When putting estate planning transactions in place, careful counsel will ensure that the client does not expressly retain an interest that would cause section 2036(a)(1) inclusion. Careful counsel will also caution the client against administering the transaction in such a way as to evidence an implied retention of such an interest. Examples include:

- A gift of the client's residence to a QPRT, when the client continues to live rent-free in the residence after the QPRT terminates;
- An installment sale of an entity interest by the client where payments on the promissory note given to the client mirror the entity's cash flow;
- A gift of art work by the client that remains on display in the client's home after the gift; and
- A gift or sale of business interests by the client after which the formalities of the business entity are not followed, the client continues to receive all of the business's cash flow as compensation or note payments, and pro-rata distributions are not made to the other interest owners.

In the post-ATRA world, the client's cavalier dealings with the property he previously transferred may actually work to his advantage. If the client has ignored the formalities attending his previous transfer and has acted as if the transferred property were still available to him, this may be enough to trigger application of Code section 2036(a)(1). If the client has made such a transfer, consider auditing the management of the transferred assets to see whether such an argument is justified.

Some commentators have gone further and suggested advising the client to take actions designed to create new evidence of a retained interest. This paper does not endorse that suggestion. We believe that Code section 2036(a)(1) applies only if the client expressly or impliedly retained and interest at the time of the transfer.[48] Manufacturing facts in this

way may create a new interest in the transferred assets but it hardly evidences an implied retention of an interest at the time of the original transfer. In light of their ethical obligations and their duty as tax return preparers, counsel should avoid recommending or participating in such an effort.

a. Income tax considerations

No income tax consequences should result from a mere audit of the handling of the transferred assets or a conclusion that, at death, Code section 2036(a)(1) will cause inclusion. If section 2036(a)(1) applies, the transferred assets included in the settlor's estate will receive an new income tax basis.

b. Transfer tax considerations

The settlor may have made a taxable gift when he made the original transfer. If so, that taxable gift should not count as an adjusted taxable gift for purposes of computing the estate tax on the settlor's estate if it is brought back into his estate under Code section 2036(a)(1).[49] Also, if the settlor paid any gift tax as a result of the original transfer, his estate may be entitled to a credit for that gift tax.[50]

c. Fiduciary duties

Assets contributed to a trust will continue to benefit the trust's beneficiaries. The trustee may have breached its duties if it participated in or allowed the Code section 2036 inclusion activities to occur and estate tax is imposed. On the other hand, the trustee or executor may breach its fiduciary duties if Code section 2036 inclusion activities occurred, the executor or trustee fails to discover them, and the beneficiaries lose the opportunity to claim a basis adjustment at the settlor's death.

d. Administrative issues

The transferor's gross estate will include the transferred assets. However, if the transferor's estate is less than $5.43 million, an estate tax return may not be required. Counsel should communicate to the beneficiaries and the personal representative about any facts that may support inclusion under Code section 2036.

If an estate tax return has been filed and did not include the transferred property in the gross estate, could a beneficiary take the position that Code section 2036 inclusion applied and therefore the transferred asset was entitled to a basis adjustment? Prior to the enactment of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 ("Highway Act"), there was authority that a beneficiary could take a basis different from the value reported on the estate tax return, and by extension of that authority, it appeared that a beneficiary could take a position that Code section 2036 inclusion applied.[51] Query, in light of the new Highway Act, can a beneficiary still argue for Code section 2036 inclusion and a basis adjustment? Perhaps the IRS will issue future guidance to clarify this issue.

e. Creditor and marital issues

If the settlor expressly or impliedly retained an interest in the transferred assets, that interest may be available to his creditors or to a spouse upon divorce. Note that, as in other cases, there may be a tension between the settlor's tax and non-tax objectives. Claiming a retained interest may achieve a tax objective but only at the risk of losing a non-tax objective.

6. Settlor, who previously created a QPRT, reacquires the residence from the remainder beneficiaries

Many long-term qualified personal residence trusts ("QPRTs") were created when the Code section 7520 rates were significantly higher than the current rate and the estate tax exclusion was a small fraction of today's $5.43 million basic exclusion amount. A client may no longer need the QPRT to shift additional assets in order to avoid estate tax. In addition, a client may desire to eliminate the restrictions associated with a QPRT and to ensure that the residence receives a basis adjustment upon the client's death.

Commutation (prepayment) of the settlor's interest in the QPRT is prohibited.[52] Effective for QPRTs created after May 16, 1996, the Treasury regulations require the QPRT's governing instrument to prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse, at any time during the original retained term, or at any time after the original retained term when the trust is a grantor trust.[53] The Treasury regulations do not prohibit a remainder beneficiary who is not a grantor trust from selling the residence to the grantor after the retained term ends.

Some commentators have suggested that the grantor might purchase the residence notwithstanding the prohibition. This approach creates three concerns:

- It implies a retained power to repurchase the residence, which could retroactively disqualify the grantor's retained interest from favorable QPRT treatment and result in a gift of the full value of the residence at the time of creation. If the grantor lacked sufficient gift tax exemption to cover the full value of the residence at the time the QPRT was created, this characterization could result in out-of-pocket gift tax that was due, but never paid. Thus, in addition to the unpaid, out-of-pocket gift tax, the grantor may also be responsible for the payment of interest and penalties.

- If the trustee sold the residence to the grantor in violation of the trust instrument, this could breach the trustee's fiduciary duty to remainder beneficiaries.

- The prohibition on sale could cloud the grantor's title and make it difficult to sell the property to a subsequent purchaser.

Commentators have also suggested that the grantor continue to reside in the residence without paying full rental value, in the hope that this could cause inclusion under Code section 2036(a)(1). This approach seems unlikely to work.

- First, arguing for such a retained interest would seem to be inconsistent with the way the QPRT transaction was initially reported for gift tax purposes.

- Second, this argument, if unsuccessful, could result in the QPRT remainder beneficiaries making a taxable gift to the grantor each year equal to the fair rental value of the property.

Even though these two approaches may not work, other approaches may.

First, if the trust instrument permits, the grantor could purchase the remainder interest in the QPRT from the remainder beneficiary in a taxable transaction (that is, so long as the remainder beneficiary is an individual or a non-grantor trust) for its actuarial value during the term of the QPRT. This proposed transaction is similar to the GRAT transaction discussed in Section III.B.3 above. The grantor would then own the term interest and the remainder interest. This should cause a merger and a termination of the QPRT, putting the residence back into the hands of the grantor where it will be subject to a basis adjustment at the grantor's death. The remainder beneficiary will be left with cash or other high-basis assets equal to the value of the remainder interest at the time of the transaction. Note that the Treasury regulations provide that the trust instrument must prohibit the trustee from "directly or indirectly" selling the residence to the grantor, but do not expressly require a prohibition on the sale of a remainder interest to the grantor by the remainder beneficiary.[54] Query: If the remainder beneficiary is a grantor trust, could the IRS assert that the grantor's purchase of a QPRT remainder interest is an indirect purchase of the residence?

Second, once the QPRT has terminated, the settlor could purchase the residence in a taxable transaction from a remainder beneficiary that is not a grantor trust. Assume the following facts are true:

- The client transferred a residence to a QPRT after May 16, 1996.

- In light of ATRA, the client no longer needs to exclude the residence from his gross estate in order to avoid estate tax. Instead, the client prefers that his gross estate include the residence so that it will obtain a new income tax basis at his death.

- The client wants to continue living in the residence after the QPRT term expires.

- The client would prefer not to pay rent to the remainder beneficiary for the following reasons:

    - After ATRA, rental payments do not produce any estate tax benefit for the client;

    - If the remainder beneficiary is not a grantor trust, paying rent would create taxable income to the remainder beneficiary with no off-setting rental deduction; and

    - The client wants to avoid the administrative complexity of a rental agreement and securing an appraisal to determine fair rental value of the residence.

- The client wants to make improvements to the residence without those improvements constituting an additional gift to the remainder beneficiary.

- The remainder beneficiary is not a grantor trust of which the client is the grantor (or, if it is, grantor trust status can be terminated, as discussed in Section X.B below).

Here is a method of achieving all of the client's goals:

- The client lends cash to the QPRT to make improvements on the residence.

- The QPRT makes the improvements. While the improvements increase the fair market value of the residence, it is unlikely that the increase equals the cost of the improvements.

- Upon termination of the QPRT, the QPRT distributes the residence to the remainder beneficiary subject to the obligation on the improvement loan.

- The client purchases the residence from the remainder beneficiary for its fair market value, as determined by an appraisal. The client pays the purchase price by:

    - Cancelling the obligation on the improvement loan; and

    - Executing and delivering a promissory note or paying cash to the remainder beneficiary for the balance.

As a result, the client recovers the residence previously transferred to the QPRT, he can continue to live in it rent-free, and the residence will receive a new income tax basis equal to its fair market value at the client's death.

a. Income tax considerations

The sale may result in gain or loss to the remainder beneficiary. Note that any loss is disallowed if the transaction is directly or indirectly between related persons.[55] Also, if there is accrued interest on the improvement loan when it is cancelled, cancellation may be tantamount to a payment of interest by the remainder beneficiary to the client and may be taxable income to the client.[56]

b. Transfer tax considerations

If the client pays fair market value for the residence, there should be no gift tax consequences.

c. Fiduciary duties

The trustee of the QPRT must consider whether borrowing funds from the client and making improvements to the residence is consistent with its fiduciary duty to the remainder beneficiary. If the remainder beneficiary is a trust, the trustee of that trust must consider whether the sale of the residence to the client is consistent with its fiduciary duty to the remainder trust beneficiaries.

d. Administrative issues

The parties should commission an appraisal to determine the fair market value of the residence. The purchase and sale agreement might also include a valuation adjustment clause. The client should consider filing a gift tax return and reporting the transaction to start the statute of limitations. Note the reduced requirements for adequate disclosure of non-gift transactions.[57]

e. Creditor and marital issues

Transferring the residence to the client, who lives in it as his principal residence, may protect it from the claims of creditors under the laws of some states.[58] If the client is married, ownership of the residence may create rights in his spouse.[59]

7. Settlor purchases a residence from a "grandfathered" QPRT

The Treasury regulations[60] do not forbid the settlor of a QPRT created before May 16, 1996, from purchasing the residence from the QPRT. Hence, in the case of a "grandfathered" QPRT, the settlor could purchase the residence from the QPRT, thereby shifting future appreciation in the residence to the settlor and ensuring that the residence will receive a new income tax basis at the settlor's death.

a. Income tax considerations

The QPRT should be a grantor trust. Hence, the purchase and sale transaction should not have income tax consequences.

b. Transfer tax considerations

If the client pays fair market value for the residence, the transaction should not have gift tax consequences. However, sale of the residence should cause the trust to cease to qualify as a QPRT. As a result, the trust assets will either be distributed to the settlor outright or converted to a retained annuity trust for the benefit of the settlor.[61]

c. Fiduciary duties

The QPRT trustee must consider whether the sale to the client/settlor is consistent with the trustee's fiduciary duties to the remainder beneficiary, particularly in light of the consequences of the trust ceasing to qualify as a QPRT.

d. Administrative issues

If the sale proceeds are to be distributed to the settlor when the trust ceases to qualify as a QPRT, then obtaining a reliable valuation of the residence would not seem critical. However, if the sale proceeds are to be converted to a retained annuity interest, reliable valuation information is more important because it determines the amount of annuity interest.[62]

e. Creditor and marital issues

Transferring the residence to the client, who lives in it as his principal residence, may protect it from the claims of creditors under the laws of some states.[63] If the client is married, ownership of the residence may create rights in his spouse.[64]

IV. Causing inclusion of trust assets in a beneficiary's estate

A. When the strategy is useful

Prior to ATRA, much estate planning revolved around designing irrevocable trusts to avoid inclusion of the trust assets in the beneficiary's gross estate. ATRA requires us to rethink that goal. If the beneficiary's gross estate is less than the beneficiary's applicable exclusion amount, including trust assets in his estate may achieve income tax savings through a basis adjustment at the beneficiary's death but at no estate tax cost.

All irrevocable trusts created with estate tax savings at the beneficiary's death in mind are potential candidates for this kind of planning, including:

- A bypass trust for a decedent's spouse;
- A testamentary trust for a decedent's child or more remote descendant;
- A remainder trust that receives assets at the termination of a GRAT or QPRT;

- A trust that acquired assets from its settlor in an installment sale transaction; and

- A trust funded by a settlor's lifetime taxable gift.

Of course, settlors often create irrevocable trusts for non-tax reasons, including:

- Providing a vehicle for managing assets for the beneficiary;

- Allowing the settlor to control the disposition of assets during the beneficiary's lifetime and at the beneficiary's death;

- Protecting assets from claims of the beneficiary's creditors and divorcing spouse;

- Facilitating distributions among multiple beneficiaries without gift tax consequences and to minimize income tax; and

- Avoiding inheritance or estate taxes imposed by the beneficiary's state of residence.

This strategy is appropriate only if the tax benefits of doing away with the trust outweigh the non-tax benefits of keeping it.

B. Implementing the strategy

1. Distribute assets based on standard

The Trustee could distribute appreciated trust assets to the beneficiary pursuant to the standard of distribution included in the trust instrument. Determining whether such a distribution is consistent with the trustee's fiduciary duty to administer the trust in accordance with its terms requires a thorough analysis of all facts and circumstances, most notably the trust instrument itself and applicable state law. For instance, the trust instrument may provide that the trustee "may" (or "shall") make distributions to the beneficiary pursuant to a health, education, maintenance, or support standard. The trustee could also have broader discretion to distribute for comfort, happiness, or some other reason. The trust instrument may also provide some additional flexibility over distributions by expressly describing the factors that the trustee "may" (or "shall") consider. A common discretionary consideration "permits" (or "requires") the trustee to consider the beneficiary's other resources. More modern trust instruments may even permit the trustee to consider distributions to minimize overall income taxes.[65] These are all important factors that should be carefully considered before a distribution is made.

a. Income tax considerations

As a general matter, trust distributions carry out distributable net income, or "DNI," to the beneficiaries. This carry-out typically results in income to the beneficiaries and a corresponding deduction to the trust.[66] After the distribution, income produced by the distributed asset will be taxed to the beneficiary rather than to the grantor of the trust (if a grantor trust) or to the trust (if not a grantor trust).

b. Transfer tax considerations

The purpose of distributing appreciated trust assets to a beneficiary in this context is to cause the assets to be included in the beneficiary's estate and receive a step-up in income tax basis at the beneficiary's death. As stated above, however, it is imperative that the distribution itself be a proper exercise of the trustee's distribution authority under the terms of the trust instrument and applicable state law. If a trustee makes distributions beyond the standard authorized in the trust instrument, the IRS may argue that the distribution should be ignored for tax purposes.[67] If the IRS is successful, the assets may be treated as if they were retained in trust and, therefore, excluded from the beneficiary's gross estate.

c. Fiduciary duties

If the distribution exceeds the standard in the trust instrument, this may violate the trustee's fiduciary duties to other beneficiaries. The trustee may be protected by an exculpatory clause in the trust instrument. If not, the trustee should consider obtaining a release and indemnity from the beneficiaries.

d. Administrative issues

The trustee should consider making a record of the factors that he relied upon in deciding to distribute assets to the beneficiary.

e. Creditor and marital issues

Assets distributed to the beneficiary will be subject to the claims of his creditors and spouse. While in the trust, those assets would likely have been shielded from those claims.

2. Change trustee to cause beneficiary to have a general power of appointment

A simple change in trustee may be enough to include the trust assets in the beneficiary's gross estate. Suppose:

- The trustee's power to distribute to the beneficiary is not limited by an ascertainable standard relating to the health, education, maintenance, or support of the beneficiary;[68] and

- The trust instrument does not prohibit the beneficiary from serving as trustee.

If the beneficiary becomes the trustee, he will likely have a general power of appointment over the trust assets, causing inclusion of the trust assets in his gross estate at death.[69]

Note that many jurisdictions have savings statutes that automatically limit the beneficiary's distribution powers to an ascertainable standard unless the trust instrument provides otherwise.[70] While these savings statutes are generally intended to avoid inadvertent mistakes or ambiguities in drafting, many statutes are relatively recent enactments and, depending on each state's legislative intent, may not apply to trusts that were irrevocable prior to the date of enactment. In these cases, the savings statutes may not apply to complicate the strategy. In cases where a savings statute would otherwise apply to a trustee-beneficiary's power to make unlimited distributions, query whether it may be possible, depending on the terms of the trust and applicable state law, to decant the trust assets to a new trust that explicitly overrides the savings statute. While this approach may be possible in some states, the answer necessarily depends on a thorough analysis of the applicable state's savings and decanting statutes.

If the trust instrument or the law of the trust situs permits division of the trust into separate trusts, consider effecting such a division, funding one trust with appreciated assets but only in that amount necessary to fully use the client's applicable exclusion amount, and funding the other trust with high-basis or loss assets. The beneficiary could then become the trustee of the former but not of the latter, achieving a step-up in basis on the appreciated assets but avoiding a step-down in basis on the depreciated assets.

a. Income tax considerations

Unless the trust is already a grantor trust, this technique should cause the beneficiary to be treated as the owner of the trust assets for income tax purposes.[71]

b. Transfer tax considerations

The change of trustee should not have gift tax consequences. However, if the trustee/beneficiary has the power to distribute trust assets to anyone other than himself, each distribution to another beneficiary will be a taxable gift, given that each distribution to a person other than the trustee/beneficiary will result in a release of the trustee/beneficiary's general power of appointment as to the distributed assets.[72] Also, the trustee/beneficiary should be the "transferor" with respect to each distribution for generation-skipping transfer tax purposes.[73] Thus, each distribution to a person more than one generation below the trustee should be a direct skip.[74] If the beneficiary later resigns or is removed as trustee, his ceasing to serve as trustee could constitute a release or lapse of his general power of appointment, triggering gift tax consequences.

c. Fiduciary duties

By taking on the role of trustee, the beneficiary assumes fiduciary duties to the other beneficiaries of the trust. Query: Does the prior trustee breach his fiduciary duty to other beneficiaries if he facilitates the creation of a general power of appointment in one of them? Or does he breach his fiduciary duty if he obstructs inclusion of the trust assets in a beneficiary's gross estate to achieve a new income tax basis?

d. Administrative issues

The trust instrument may provide a non-judicial mechanism for trustee substitution. If not, court action may be necessary to approve the resignation of the former trustee and the appointment of the beneficiary as the new trustee. Again, depending on the terms of the trust and applicable state law, it may be possible to decant the trust assets to a new trust that specifically provides a non-judicial mechanism for trustee substitution.[75] The trustee/beneficiary may need to file a gift tax return if he distributes trust assets to anyone other than himself.

e. Creditor and marital issues

Depending upon applicable state law, substituting the beneficiary as the trustee and thus giving him control over the trust assets not limited by an ascertainable standard may give his creditors and his spouse greater access to the trust assets to satisfy their claims.

3. Independent party grants beneficiary a general power of appointment

Some trust instruments give an independent third party the power to grant the beneficiary a general power of appointment. In that case, the third party could simply grant that power and the trust assets should be includible in the beneficiary's gross estate.

If the trust contains both appreciated and depreciated assets, the third party could grant the beneficiary a general power of appointment with respect to the former but not the latter, achieving a step-up in basis for appreciated assets but avoiding a step-down in basis for depreciated assets. Alternatively, the trustee could divide the trust into two separate trusts as described in Section IV.B.2 above.

a. Income tax considerations

If the general power of appointment includes the power to appoint to the beneficiary himself, the beneficiary should be taxed on trust income under Code section 678, unless the trust is otherwise a grantor trust as to the settlor.[76]

b. Transfer tax considerations

If the trustee (other than the holder of the power of appointment) can distribute trust assets to beneficiaries other than the holder of the power of appointment, each

distribution to another beneficiary will cause the power of appointment to lapse as to the distributed assets. Each such lapse may constitute a gift by the power-holding beneficiary if the lapse exceeds the "five and five" amount.[77]

c. Fiduciary duties

State law and the trust instrument should be consulted to determine whether the third party has fiduciary duties toward the trust beneficiaries in connection with the decision of whether to grant a general power of appointment. For example, if the third party declines to grant such a power and beneficiaries incur greater capital gains tax as a result, is the third party subject to liability?

d. Administrative issues

The general power of appointment can be structured to make it difficult to exercise. For example, (i) the exercise can require the consent of a third party who does not have an interest in the trust; (ii) the objects of the power can be limited to the donee's creditors; and (iii) the power can be exercisable only with prior notice.[78]

e. Creditor and marital issues

In some states, a beneficiary's mere possession of a general power of appointment will not expose the trust assets to the beneficiary's creditors; rather, those creditors can reach the trust assets only if the beneficiary actually exercises the power. In other states, the beneficiary's mere possession of a general power of appointment will allow the beneficiary's creditors to reach the trust assets to satisfy their claims.[79]

Also, some states may grant the beneficiary's spouse additional marital rights in property subject to the beneficiary's general power of appointment. For example, property subject to the beneficiary's general power may be taken into account in determining the spouse's elective share in the beneficiary's estate.[80]

Before implementing this technique, counsel should consult state law to determine whether it would create an unacceptable risk of subjecting the trust assets to spousal or creditor claims.

4. Exercise non-general power of appointment to intentionally trigger the Delaware tax trap

In a limited number of cases it may be possible for a beneficiary of an irrevocable trust to utilize the Delaware Tax Trap ("DTT") to cause appreciated trust assets to be included in the beneficiary's gross estate and thus obtain a basis adjustment at the beneficiary's death. While the Delaware Tax Trap is complicated and a detailed analysis of its application is beyond the scope of this paper, several authors have written excellent articles on this technique.[81]

Normally, if a person holds a non-general power of appointment, the exercise or lapse of the power will not cause the trust assets subject to the power to be included in the holder's gross estate.[82] However, the holder of the power may be able to cause the trust assets to be included in the holder's gross estate and thus achieve a basis adjustment upon the holder's death if the non-general power of appointment is exercised to create another power of appointment that can be exercised in a manner to postpone the vesting of an interest in the property for a period determined without regard to the time the first power was created.[83]

<u>Example</u>: *Husband died and created a bypass trust for the benefit of Wife. Wife is the primary beneficiary during her lifetime and is granted a testamentary non-general power of appointment. The bypass trust assets have realized significant appreciation but will not receive a basis adjustment at Wife's death since the assets will not be included in Wife's gross estate. Wife does not have sufficient assets to fully take advantage of her applicable exclusion amount. If Wife exercises the power of appointment in a manner that triggers the DTT, the appointed assets will be included in Wife's gross estate and benefit from a stepped-up basis without generating an estate tax.*

Some states have enacted savings statutes so that vesting under the Rule Against Perpetuities is not extended by exercise of a non-general power of appointment.[84] These statutes were designed to prevent a holder of a non-general power of appointment from inadvertently triggering the DTT and causing the assets subject to the power to be included in the holder's gross estate. Further, many trust instruments have been drafted in an effort to prevent the exercise of a non-general power of appointment in a manner that might trigger the DTT.

In most states, the holder of a non-general power of appointment can trigger the DTT by exercising the power and creating a second presently exercisable power of appointment over all or part of the trust, or by granting a presently exercisable general power of appointment to a beneficiary.[85] Under common law and the law of most states, the holder's exercise of the power in manner that only grants a non-general power of appointment will not trigger the DTT.[86] However, the Uniform Statutory Rule Against Perpetuities ("USRAP"), which has been adopted by most states, may allow the DTT to be tripped when a holder of a non-general power of appointment appoints assets to a different trust that grants only a non-general power or appointment.[87]

Many states have abolished the Rule Against Perpetuities or have enacted very long fixed periods from 100 years to 1,000 years. While triggering the DTT in those states may be more challenging, it can be accomplished by restarting the fixed period, similar to extending the Rule Against Perpetuities period.

a. Income tax considerations

The DTT can facilitate a new income tax basis in trust assets that would otherwise not be available. The trust assets subject to the DTT will be includable in the beneficiary's gross estate and will receive a basis adjustment at the beneficiary's death. Significant income

tax savings can be realized, especially if the DTT applies only to trust assets with appreciation.

The beneficiary's exercise of the non-general power of appointment should be designed to maximize the potential income tax benefits of triggering the DTT. The exercise can utilize a formula designed to apply first to trust assets with the most appreciation until the formula amount is satisfied.

As an alternative or complement to the formula exercise, consider dividing the trust into two separate trusts. One trust, which will be subject to the DTT, can be funded with appreciated assets (in order to obtain a basis adjustment upon the beneficiary' death) while the other trust, which will not be subject to the DTT, can be funded with high basis assets and assets with a basis in excess of fair market value (in order to preserve basis). Many states authorize the division of a trust without court action, provided that the division does not impair the rights of any beneficiary or adversely affect the purposes of the original trust.[88]

b. Transfer tax considerations

Triggering the DTT will cause the appointed trust assets to be included in the gross estate of the beneficiary exercising the power of appointment. No estate tax will result if the beneficiary exercising the power of appointment has "excess" applicable exclusion amount and the value of the assets included in the beneficiary's gross estate as a result of triggering the DTT does not exceed the amount of the remaining applicable exclusion amount. Consider utilizing a formula exercise that applies only to trust assets with a value that will not cause the beneficiary's estate to exceed the applicable exclusion amount.

If, under applicable state law, triggering the DTT requires the beneficiary to grant to another party a presently exercisable general power of appointment, then the appointed assets will be subjected to estate tax in two estates: that of the beneficiary who exercises the power (under the DTT rule) and that of the party to whom the new power is granted (under the usual provisions of Code section 2041). Counsel should be certain that the income tax benefits of including assets in the beneficiary's state outweigh the combined estate tax costs in both estates.

The beneficiary should also consider the potential GST tax consequences of triggering the DTT. The beneficiary who triggers the DTT will become the new transferor of the appointed assets. Persons who are skip persons with respect to the original grantor may not be skip persons as to the beneficiary who triggered the DTT. This occurrence may facilitate distributions free of the 40% GST tax. Additionally, even if those persons are skip persons, the beneficiary who triggered the DTT may allocate available GST tax exemption to the appointed assets, potentially eliminating any GST tax.

Finally, triggering the DTT may waste previously allocated GST tax exemption. If the DTT is triggered with respect to a trust that is exempt from GST tax, those trust assets,

which would have passed to future generations free of estate or GST tax, will be included in the beneficiary's gross estate and will no longer be exempt from GST tax unless the beneficiary has available GST exemption that is applied to the assets.[89]

c. Fiduciary duties

The exercise of a non-general power of appointment by a beneficiary does not implicate a trustee's fiduciary duties.

If a trustee divides a trust into two separate trusts, one holding low basis assets and a second holding assets with basis in excess of fair market value, the trustee will be taking an action that may affect the beneficiaries, although both trusts continue to be subject to the same terms and conditions as the original trust.

d. Administrative issues

The beneficiary must exercise the non-general power of appointment in accordance with state law and the terms of the trust instrument.

The beneficiary should identify the trust's assets with appreciation or loss and consider structuring the exercise using a formula or perhaps divide the trust into two separate trusts, one with appreciated assets (which will be subject to the DTT) and the other with high basis or loss assets (which will not be subject to the DTT).

e. Creditor and marital issues

Since the exercising beneficiary only held a non-general power of appointment, the beneficiary's exercise of that power should not increase the rights of the beneficiary's creditors or spouses to reach the appointed assets, even if such assets are included in the beneficiary's gross estate.

If the appointed assets are subject to a lifetime general power of appointment they will be exposed to creditors and spousal claims of the new beneficiary.

5. Purchase assets from an Section 678 trust

Section 678 of the Code provides that, under certain circumstances, a non-grantor beneficiary of a trust will be treated for income tax purposes as if he owned the trust assets. As a result, all items of income, deduction, and credit of the trust will be included in computing the beneficiary's taxable income and credits. This paper refers to such a trust as a "Section 678 trust."

If the client is a beneficiary of a Section 678 trust and the trust holds assets with appreciation potential, the client could purchase the appreciating assets from the trust, thereby freezing the value of the trust assets and shifting future appreciation to himself.

a. Income tax considerations

Because the beneficiary is deemed to own the trust assets, the transaction should be free of income tax.

b. Transfer tax considerations

There should be no transfer tax consequences, provided the beneficiary pays adequate and full consideration for the assets purchased from the trust. The beneficiary should consider including a valuation adjustment clause in the transaction documents to fortify the goal of paying fair market value.

c. Fiduciary duties

The trustee's fiduciary duties to beneficiaries other than the purchasing beneficiary (*e.g.*, remainder beneficiaries) should be the same regardless of whether the purchaser is a beneficiary or the settlor. Hence, as to those other beneficiaries, the comments in Section III.B.2.c above apply.

One might think that the purchasing beneficiary's participation in the transaction would prevent him from asserting that the sale breached the trustee's fiduciary duty to him. However, it is easy to imagine that, if the value of the purchased asset were to decline, the purchasing beneficiary might argue that the trustee had a fiduciary duty to warn the beneficiary against entering into the transaction. The prudent trustee will demand a release and indemnity even from the purchasing beneficiary.

d. Administrative issues

The client should consider reporting the transaction on a timely filed gift tax return in an effort to start the running of the statute of limitations. Note the reduced requirements for adequate disclosure of non-gift transactions.[90]

e. Creditor and marital issues

Generally, the transaction will not affect potential creditor claims since the beneficiary must pay adequate and full consideration for the purchased assets. However, additional creditor protection may be achieved if the beneficiary receives assets that, in many states, are afforded additional protection from the claims of creditors (*e.g.*, annuities, life insurance policies, limited partnership interests, etc.).

6. Avoid funding bypass trust upon a death of a spouse with an "outdated" estate plan

Prior to ATRA, conventional estate planning for the affluent married client involved two principal gifts:

- A gift of the deceased spouse's applicable exclusion amount to a "bypass" trust for the primary benefit of the surviving spouse; and

- A gift of the balance of the estate to or for the benefit of the surviving spouse in some form that qualified for the marital deduction.

The client could achieve deferral of estate tax until the surviving spouse's death simply by making a marital deduction gift of his entire estate. However, such a plan would waste the client's unified credit and therefore pass up the opportunity to transfer assets in a way that not only deferred, but actually avoided, estate tax.

The bypass trust solved the problem. It allowed the client to give the surviving spouse the use and enjoyment of the property during her lifetime. However, because the surviving spouse's powers over and interests in the trust were sufficiently circumscribed, the trust assets were not included in her gross estate at death. Thus, the bypass trust achieved the benefit of a marital deduction gift (giving the surviving spouse the benefit of the property) but without the tax detriment (inclusion of the property in the surviving spouse's gross estate).

ATRA changes all of this. The basic exclusion amount can now shelter much more property, and it is portable. If the client's and the spouse's combined estates are below their combined basic exclusion amounts (currently $10,680,000), they can avoid estate tax with the marital deduction and portability; they do not need a bypass trust for this purpose. (However, note our discussion below, to the effect that portability will not apply to assets received by a spouse as a result of not funding a credit shelter trust.) Although the bypass trust may still be worthwhile for non-tax purposes (*e.g.*, creditor protection, management, control of distributions, control of ultimate disposition, etc.), it offers very little in the way of estate tax benefit other than keeping future appreciation on the deceased spouse's property out of the surviving spouse's gross estate.

And while the bypass trust may no longer offer significant estate tax advantages, it results in several disadvantages. Those include increased complexity, additional income tax returns, the need to plan to avoid income tax at the trust level, segregation of assets, additional fiduciary duties, and loss of basis adjustment at surviving spouse's death.

If a client dies with an estate plan creating a bypass trust, consider ways in which to avoid funding the trust but instead distributing the trust assets to the surviving spouse free of trust. Options include:

- A family settlement agreement;

- Judicial reformation of the trust; and

- Judicial modification or termination of the trust.

With regard to the first option listed above, some states' laws (Texas, for example) permit the use of a "family settlement agreement" to alter the disposition of assets otherwise provided for in a will or trust instrument otherwise. Assuming the family members (and other beneficiaries) consent, a simple agreement may be effective to shift trust assets into the hands of one or more beneficiaries. As explained below, however, family settlement agreements raise a variety of tax and non-tax issues.

Somewhat similarly, some states' laws permit a court to modify or terminate a trust if, for example:

- The purposes of the trust have been fulfilled or have become illegal or impossible to fulfill;
- Because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust;
- Modification of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration;
- The order is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intentions; or
- Continuance of the trust is not necessary to achieve any material purpose of the trust, or the order is not inconsistent with a material purpose of the trust.[91]

In light of ATRA, the trust beneficiaries may be able to persuade a court to terminate a trust under one of the grounds set forth above in order to achieve the income tax benefits of holding the trust assets outright.

a. Income tax considerations

This technique substitutes the surviving spouse, as well as any other beneficiaries, for the trust as the owner(s) of assets and as the taxpayer(s) with respect to income attributable to those assets. This substitution may yield a positive or negative income tax result depending on the facts and circumstances of each trust. For instance, although trusts reach the top federal income tax bracket after earning just $12,300 of income (in 2015), because trust distributions carry out DNI to the beneficiaries, sophisticated trustees can manage overall income tax liability by making targeted distributions to specific trust beneficiaries (*e.g.*, the trustee could make distributions to children, who are in lower income tax brackets, instead of to the surviving spouse, who may be in a higher income tax bracket). Without the continuing presence of a trust, the ability to spread income tax liability amongst beneficiaries would be lost.

b. Transfer tax considerations

Failing to fund a bypass trust at the first spouse's death, or otherwise terminating a trust during the surviving spouse's lifetime, is fraught with potential transfer tax risks. For example, a family settlement agreement among the surviving spouse and children to not fund the bypass trust, or a judicial modification or termination having that effect, would likely include the children's consent and/or release. Under basic gift tax principles, it is possible that the children could be deemed to make a gift to the surviving spouse by releasing their remainder interests in the bypass trust for less than full and adequate consideration.[92] Query, then, whether the children could receive a portion of the assets otherwise distributable to the bypass trust to avoid unintended gift tax consequences?

In the case of an existing bypass trust, if the trust assets are distributed among the beneficiaries in accordance with the value of their interests, there should be no gift tax consequences. If the trust assets are distributed to one or more beneficiaries to the exclusion of others, however, the excluded beneficiaries may make taxable gifts to the other beneficiaries.

In these circumstances where taxable gifts are being made, query how the beneficiaries or the IRS would determine the fair market value of such gifts? Most likely, determining fair market value would require detailed analysis of the surviving spouse's life expectancy, her available resources outside of the trust, and the impact of specific trust terms (*e.g.*, whether the trustee "shall" or "may" distribute assets to the surviving spouse, whether the surviving spouse possesses an inter vivos or testamentary power of appointment, etc.). Issues such as these place advisors in precarious positions, particularly when the advisor represents the surviving spouse in a fiduciary capacity, and not the beneficiaries in their individual capacities.

In addition to valuation issues, query how the IRS would treat the failure to fund a bypass trust at the first spouse's death for purposes of portability? For example, if Husband died with a $2 million estate that should all pass to a bypass trust, but surviving Wife and Children entered into a family settlement agreement distributing the entire $2 million outright to Wife, how much of Husband's unused basic exclusion amount is Wife able to port? It appears that Wife can only port $3.43 million because Husband used $2 million of exclusion by directing that assets should pass to the bypass trust, which Wife and Children simply failed to fund. Even though Wife would ultimately receive that $2 million, she would receive it by virtue of an agreement with Children and not by virtue of a transfer from Husband, so Husband's estate should not receive a marital deduction for those assets under Code section 2056.[93] Instead, the $2 million gift to the bypass trust would consume $2 million of Husband's applicable exclusion amount.

In any case, the GST exemption is not portable, so not funding a bypass trust may forgo the opportunity to pass those assets to skip persons free of tax.

c. Fiduciary duties

Executors and trustees have a fiduciary duty to administer the assets of an estate or trust in accordance with the terms of the will or trust instrument. Consequently, making a distribution that is inconsistent with those terms would violate the executor's or trustee's fiduciary duty. Moreover, unless all beneficiaries agree, the trustee may have a fiduciary duty to oppose a judicial modification or termination of a trust. Despite his duties, the trustee should incur no liability if all beneficiaries agree to the distribution, modification, or termination, as the case may be, and release the trustee from any liability.

d. Administrative issues

In a bypass trust, a spendthrift provision may protect the interests of the remainder beneficiaries from disposition by the surviving spouse. Absent a trust, the surviving spouse may sell, consume, or redirect assets to other parties.

A judicial modification or termination requires a court proceeding. Special care should be taken to ensure that any court order (or any non-judicial family settlement agreement) binds minor, unborn, and unascertained beneficiaries.

e. Creditor and marital issues

While in the trust, assets may be protected from claims of the beneficiaries' creditors and spouses. After termination of the trust, assets may be subject to those claims.

7. Decant to another trust

Some states allow the "decanting" of trusts—that is, the transfer of trust assets to another trust for the benefit of one or more of the same beneficiaries.[94] For example, in Texas a trustee with "full discretion" (*i.e.*, the power to distribute principal without limitation) can transfer the trust assets to a second trust for the benefit of one or more beneficiaries of the first trust and can grant the beneficiaries of the second trust powers of appointment over the trust assets.[95]

Consider decanting to a second trust and granting the beneficiary a general power of appointment over the second trust's assets. This should preserve some of the benefits of the trust vehicle while ensuring that the trust assets receive a new income tax basis at the beneficiary's death. Note, however, that because decanting statutes vary widely from state to state, the effectiveness of this strategy will depend almost entirely on the terms of the trust instrument and applicable state law. For instance, many state decanting statutes contain broad tax savings provisions that may apply under certain circumstances to preclude the use of decanting to grant a beneficiary a general power of appointment over the second trust's assets or otherwise cause the inclusion of the trust's assets in the beneficiary's estate.[96]

a. Income tax considerations

In most cases, decanting assets from one domestic trust to another will generate minimal, if any, income tax consequences because the old trust and the new trust should be treated as the "same trust" for income tax purposes or, in the alternative, the transfer of assets should merely carry out the old trust's distributable net income ("DNI"), resulting in income to the new trust with a corresponding distribution deduction for the old trust. Decanting may trigger income tax, however, if it (i) converts a grantor trust to a non-grantor trust and (ii) the assets appointed include negative basis assets.[97]

b. Transfer tax considerations

In any decanting, it is important to consider whether the decanting could result in any unintended estate, gift, or GST tax consequences.

Because we are attempting to include trust assets in a beneficiary's gross estate, estate tax issues should not be a major concern in this context.

It is important to structure the decanting to reduce the risk of unintended taxable gifts. Many state statutes have savings provisions to prevent taxable gifts from being made.[98] Furthermore, as a general rule, decanting should not trigger gift tax consequences so long as (i) the trustee exercising the decanting authority is not a trust beneficiary (who is not limited by an ascertainable standard of distribution), (ii) the trustee's ability to decant is not contingent on obtaining beneficiary consent, and (iii) the Delaware tax trap does not apply.

Decanting by itself should cause no GST tax issues, at least if the second trust, to which the trust assets are distributed, is not a "skip person."[99] However, if the decanted trust is exempt from GST tax, either because it is grandfathered or it has a zero inclusion ratio, then decanting to a second trust that grants a beneficiary a general power of appointment will forfeit the exemption from GST tax that the trust assets enjoyed while in the first trust.

Unfortunately, the IRS has placed decanting on its no ruling list with respect to most transfer tax issues.[100] Consequently, even if a trustee wanted to obtain a ruling from the IRS on the tax consequences of a decanting, the trustee would be unable to do so.

c. Fiduciary duties

Prior to exercising decanting authority, the trustee must determine that decanting is consistent with the discharge of its fiduciary duties, including the duties of due care, good faith, loyalty, and impartiality among the beneficiaries.[101] When a decanting involves only administrative changes, the trustee's fiduciary duties should not be seriously implicated. A decanting could implicate such fiduciary duties, however, if it involves changing the nature of a beneficiary's interest in the trust. For instance, if the new trust grants a current beneficiary a general power of appointment to cause estate inclusion, a

remainder beneficiary may complain that the terms of the new trust negatively affect his or her remainder interest in the trust and, therefore, constitute a breach of the trustee's duties of loyalty and impartiality. Although it would seem advantageous to obtain consent, or perhaps a release and indemnification, from the settlor, if living, and from all trust beneficiaries, these measures could have adverse gift tax consequences for the settlor and/or the beneficiaries and are not generally recommended.[102] Therefore, before a trustee exercises decanting authority, the trustee should carefully weigh the benefits to be achieved against the associated risks of fiduciary liability.

d. Administrative issues

Although decanting does not typically require the parties to go to court, there are a number of specific decanting procedures present in most state statutes. Common decanting requirements include giving notice to the trust beneficiaries (and to the state's attorney general in the case of charitable trusts), executing a form of decanting instrument, and maintaining the decanting documents in the books and records of the old and new trusts. Because these requirements vary widely from state to state, trustees must be certain to consult and adhere to applicable state law when exercising decanting authority. Other administrative issues may arise in a decanting, such as whether to retitle assets in the name of the new trust and whether to obtain a new taxpayer identification number for the new trust.

e. Creditor and marital issues

Because assets will continue to be held in trust after a decanting, it is unlikely that any creditor or marital issues will arise in a decanting that is otherwise proper under the terms of the trust and applicable state law. Granting a beneficiary a general power of appointment over assets in the new trust, however, may expose such assets to the beneficiary's creditors or spouse, either during lifetime or upon death.

8. Cause a non-exempt GST trust to be included in estate of non-skip person to avoid a taxable termination and imposition of a 40% GST tax

Assume that the beneficiary's parent created a trust for the beneficiary, the trust lasts for the beneficiary's lifetime, and upon the beneficiary's death the trust assets pass to his children. Termination of the trust would constitute a "taxable termination" for generation-skipping transfer tax purposes.[103] Unless the trust's inclusion ratio[104] is zero, this may expose the trust assets to a 40% generation-skipping transfer tax at the beneficiary's death.

Consider whether it is possible to confer a general power of appointment upon the beneficiary so that the trust assets will be included in the beneficiary's gross estate under Code section 2041.[105] This should make the beneficiary the "transferor" of the trust assets for generation-skipping transfer tax purposes.[106] The beneficiary's death should not be a taxable termination because the trust assets will pass to his children, who are not

"skip persons" with respect to the beneficiary.[107] As a result, the trust assets will be subjected to the estate tax rather than the generation-skipping transfer tax at the beneficiary's death. Assuming the beneficiary has enough basic exclusion amount to shelter the trust assets, this results in shifting the trust assets from a taxing regime that imposes a tax to one that does not.

a. Income tax considerations

If the general power of appointment includes the power to appoint to the beneficiary himself, the beneficiary should be taxed on trust income under Code section 678, unless the trust is otherwise a grantor trust as to the settlor.[108]

b. Transfer tax considerations

If the trustee (other than the holder of the power of appointment) can distribute trust assets to beneficiaries other than the holder of the power of appointment, each distribution to another beneficiary will cause the power of appointment to lapse as to the distributed assets. Each such lapse may constitute a gift by the power-holding beneficiary if the lapse exceeds the "five and five" amount.[109] Also, distributions to persons in the first generation below the beneficiary (*e.g.*, children) will not be taxable distributions.

c. Fiduciary duties

State law and the trust instrument should be consulted to determine whether the third party has fiduciary duties toward the trust beneficiaries in connection with the decision of whether to grant a general power of appointment. For example, if the third party declines to grant such a power and beneficiaries incur greater capital gains tax as a result, is the third party subject to liability?

d. Administrative issues

The general power of appointment can be structured to make it difficult to exercise. For example, (i) the exercise can require the consent of a third party who does not have an interest in the trust; (ii) the objects of the power can be limited to the donee's creditors; and (iii) the power can be exercisable only with prior notice.[110]

e. Creditor and marital issues

In some states, a beneficiary's mere possession of a general power of appointment will not expose the trust assets to the beneficiary's creditors; rather, those creditors can reach the trust assets only if the beneficiary actually exercises the power. In other states, the beneficiary's mere possession of a general power of appointment will allow the beneficiary's creditors to reach the trust assets to satisfy their claims.[111]

Also, some states may grant the beneficiary's spouse additional marital rights in property subject to the beneficiary's general power of appointment. For example, property subject

to the beneficiary's general power may be taken into account in determining the spouse's elective share in the beneficiary's estate.[112]

Before implementing this technique, counsel should consult state law to determine whether it would create an unacceptable risk of subjecting the trust assets to spousal or creditor claims.

9. Make a late QTIP election for a bypass trust

The typical bypass trust (i) will not designate the surviving spouse as the sole beneficiary, (ii) prevent the surviving spouse from appointing to anyone else during her lifetime, and (iii) require the trustee to distribute all trust income to the surviving spouse currently. However, if it does, then the trust may qualify for treatment as QTIP trust under Code section 2056(b)(7). If the decedent's estate did not file an estate tax return, it may be possible to file a late return and make the QTIP election even long after the decedent's death.[113] The trust assets would then be included in the surviving spouse's gross estate under Code section 2044 and would receive a new income tax basis at the surviving spouse's death.[114]

a. Income tax considerations

The late election should have no income tax consequences.

b. Transfer tax considerations

The late election should have no gift tax consequences. Of course, it will result in inclusion of the trust assets in the surviving spouse's gross estate. However, the surviving spouse cannot use the deceased spouse's unused exclusion amount because, to do so, the decedent's executor must elect portability on a timely-filed estate tax return.[115]

c. Fiduciary duties

If the trustee is someone other than the spouse, consider whether the trustee has a fiduciary duty to make the QTIP election.

d. Administrative issues

This technique requires filing an estate tax return for the decedent's estate. Consider who files the return and makes the election in the case of a decedent's estate that has already been closed.[116]

e. Creditor and marital issues

There should be no change in a creditor's or spouse's rights in the trust assets.

V. Causing inclusion of trust assets in a third party's estate

A. When the strategy is useful

If a trust settlor or beneficiary already has assets greater than his or her applicable exclusion amount, the strategies described in Articles III and IV above may not be helpful. Using them would simply subject assets to estate tax when they otherwise would be free of estate tax.

However, in a limited number of cases it may be possible to take advantage of a third party's excess applicable exclusion amount. That is, it may be possible to subject the appreciated trust assets to inclusion in a third party's gross estate, thereby obtaining a new income tax basis at the third party's death, without significantly impairing the overall estate plan.

B. Implementing the strategy

1. Exercise a non-general power of appointment in favor of an elderly or ill family member

If the trust instrument grants the beneficiary a non-general power of appointment that permits appointment of assets to a person (*e.g.*, a spouse or other relative) who may have excess applicable exclusion amount and a shorter life expectancy than the beneficiary, consider having the beneficiary exercise the power in such a way that the assets will be included in the appointee's gross estate. The assets will then receive a new income tax basis at the appointee's death but at no estate tax cost due to the appointee's applicable exclusion amount.

An appointment free of trust is simple to effect for this purpose, but it also puts the appointed assets in the hands of the appointee, who may dispose of them in a way the beneficiary did not anticipate. To protect against this, consider having the beneficiary appoint the trust assets to a trust for the benefit of the appointee that:

- Gives the appointee a general power of appointment, but one that is "difficult" to exercise;[117] and
- Provides that, if the general power is not exercised, the trust assets will remain in trust for the benefit of the original beneficiary.

a. Income tax considerations

Appointing trust assets outright to a third party or a trust for the benefit of a third party that is not a grantor trust as to the grantor of the original trust will change the identity of the taxpayer with respect to income generated by those assets.

Generally, property that is includible in a decedent's gross estate for federal estate tax purposes receives a new income tax basis equal to the fair market value of the property

on the date of the decedent's death.[118] However, Code section 1014(e) provides that the new basis at death rules do not apply to appreciated property received by the decedent by *gift* during the one-year period ending on the date of the decedent's death if such property is acquired from the decedent by (or passes from the decedent to) the donor of such property or the donor's spouse.

Query, will Code section 1014(e) apply to prevent a basis adjustment where the decedent received property through the exercise of a lifetime non-general power of appointment and such property passes back to the power-holder within one year? The issue is whether the exercise of a non-general power counts as a "gift" for purposes of 1014(e).

We begin with the assumption that a gift requires a transfer from the donor to the donee. For transfer tax purposes, the exercise of a non-general power can result in a transfer by gift if the power-holder has an interest in the property that he relinquishes as a result of the exercise.[119] However, there is also authority to the effect that, for income tax purposes, the exercise of a non-general power of appointment is not a transfer by the power-holder.[120] While this issue is not free from doubt, we believe that the better result is that the exercise of a non-general power is not a transfer by the power-holder and, therefore, not a gift for purposes of Code section 1014(e).

Even if the exercise of a non-general power constitutes a gift by the power-holder, Code section 1014(e) should not apply to prevent a basis adjustment if the deceased appointee transfers the property to or for the benefit of a person other than the power-holder. The IRS has taken the position that Code section 1014(e) will prevent a basis adjustment where the appreciated property passed to a trust for the benefit of a donor and his descendants.[121] However, we consider that to be an open question, and a transfer by the deceased appointee to a trust for the primary benefit of the power-holder may not trigger Code section 1014(e).

Several other outlines address this subject in detail.[122]

b. Transfer tax considerations

Normally the exercise of a non-general power of appointment is not a gift for gift tax purposes. However, if the beneficiary has a right to distributions from trust assets, appointment of the trust assets to another party may be a gift equal to the value of the beneficiary's right to distributions.[123]

c. Fiduciary duties

Normally, there is no fiduciary duty either to exercise or refrain from exercising a non-general power of appointment.

d. Administrative issues

The trust instrument or applicable state law may govern the procedure for exercising a power of appointment.

e. Creditor and marital issues

Exercising a power of appointment may subject the appointed assets to the claims of the appointee's creditors and spouse.

2. Exercise non-general power of appointment in favor of a spouse who leaves the property to other spouse

This technique is similar to the transaction described in Section V.B.1 above.

Assume the following:

- The beneficiary of a trust has a lifetime non-general power of appointment over the trust assets;
- The power of appointment permits appointment to a class of persons that includes the beneficiary's spouse;
- Some of the trust assets have appreciated in value;
- The trust assets are not includible in the beneficiary's gross estate; and
- The value of the beneficiary's and the spouse's assets outside the trust is substantially less than their combined applicable exclusion amounts.

The beneficiary could appoint appreciated assets to the beneficiary's spouse, thereby achieving a step-up in basis at the spouse's death. If the beneficiary survives the spouse, presumably the appointed assets will come back to the beneficiary. If not, they will go to the beneficiary's and the spouse's descendants.

Note that this technique is safe only if there is a stable marriage and the ultimate objects of both spouses' bounty are the same.

a. Income tax considerations

See V.B.1.a above.

b. Transfer tax considerations

Normally the exercise of a non-general power of appointment is not a gift for gift tax purposes. However, if the beneficiary has a right to distributions from trust assets,

appointment of the trust assets to another party may be a gift equal to the value of the beneficiary's right to distributions.[124]

c. Fiduciary duties

Normally, there is no fiduciary duty either to exercise or refrain from exercising a non-general power of appointment.

d. Administrative issues

The trust instrument or applicable state law may govern the procedure for exercising a power of appointment.

e. Creditor and marital issues

While it is typically assumed that property appointed to one spouse will pass back to the other spouse (or to the spouses' common beneficiaries) upon the appointee spouse's death, this may not always be the case. Because the appointed property would likely be characterized as the appointee spouse's separate property, the appointing spouse may not have access to or control over the property in the event of death or divorce. Moreover, this separate property characterization will impact creditors' rights over the property in the event of a judgment against one or both spouses.

3. Add or change beneficiaries

Some practitioners designate a "power-holder" or "trust protector" in an irrevocable trust and give that person the power to add or change beneficiaries of the trust. If the trust in question designates such a person, he can exercise that power and add other persons as beneficiaries of the trust. If this results in granting the new beneficiary a general power of appointment or authorizing the trustee to make substantial distributions to the new beneficiary, then the trust assets can pass through the new beneficiary's estate and receive a new income tax basis while still avoiding estate tax through use of the new beneficiary's applicable exclusion amount.

a. Income tax considerations

If the trust includes the power to add beneficiaries, the trust will likely be a grantor trust.[125] Hence, if the trust instrument includes this flexibility, the strategy described in Section IX below will not be available unless, after adding new beneficiaries, the power-holder releases the power.

b. Transfer tax considerations

If the added beneficiaries are "skip persons" for generation-skipping transfer tax purposes[126] and the trust does not have a zero inclusion ratio, this solution may result in a "taxable termination"[127] when the trust terminates or in a "taxable distribution"[128] when distributions are made to "skip person" beneficiaries from the trust.

c. Fiduciary duties

If the trust limits the power-holder's duties and exonerates the power-holder from liability, exercise of the power to add or change beneficiaries should not breach any fiduciary duty of the power-holder to a beneficiary.

d. Administrative issues

Any exercise of the power to add or change beneficiaries should be appropriately documented. The trustee may have a duty to provide this information to the beneficiaries.[129]

e. Creditor and marital issues

Depending upon the terms of the trust, a change in beneficiaries may alter the extent to which trust assets are exposed to creditor and marital claims. For example, if the power-holder substitutes a beneficiary with significant exposure to creditor and marital claims for one who has little or no exposure, the assets of the trust will be at risk if they are distributed to that beneficiary.

VI. Causing inclusion of gifted assets (not in trust) in the donor's estate

A. When the strategy is useful

Suppose a client transferred assets to family members free of trust to avoid inclusion of those assets and their future appreciation in his gross estate. In light of ATRA's increased applicable exclusion amount, inclusion of the previously gifted assets in the client's estate may secure the benefit of a new, higher income tax basis without the burden of incurring estate tax. Thus, reversing course and including the previously-transferred assets in the client's gross estate may work to the overall benefit of the family.

This strategy may have two benefits. First, it may result in bringing a transferred asset back into the transferor's gross estate, qualifying it for a basis adjustment at his death. Second, it may result in eliminating features of the asset that would justify a valuation discount, enhancing the basis increase.

<u>Example</u>: *Client made annual exclusion gifts of fractional interests in artwork to children during his lifetime with the objective of minimizing estate tax upon client's death. However, the artwork continued to be in client's possession. Client died with some of the artwork owned entirely by children while other artwork was owned fractionally by client and children. All of the artwork had a nominal income tax basis. If the artwork interests gifted to children are not included in client's estate, they will retain a nominal income tax basis and the basis adjustment for client's fractional interests in artwork will reflect a discount. In contrast, if the value of client's assets plus the gifted artwork is less than client's applicable exclusion amount, inclusion of the artwork in client's gross estate will not generate an estate tax and will facilitate a full basis adjustment. The basis*

adjustment is especially important since collectibles can be subject to the higher capital gains rate of 28%.[130]

B. Implementing the strategy

1. Identify actions that may have triggered Code section 2036(a)(1)

If the client has ignored the formalities attending his previous transfer and acted as if the transferred property were still available to him, this may be enough to trigger application of Code section 2036(a)(1). Consider auditing the management of the transferred assets to see whether such an argument is justified.

This is similar to the technique described in Section III.B.5 above, although the occasions for its use are probably fewer in the case of property transferred outright as opposed to property transferred in trust. Possibilities include:

- The client transferred mineral interests or other real estate but continued to receive the revenues or occupied the property;
- The client transferred business interests but continued to receive all of the cash flow as compensation or "loans"; or
- The client transferred artwork but continued to display it in his home.

If the facts suggest an implied agreement at the time of the transfer that the client would retain enjoyment of the gifted property, the Internal Revenue Service may assert inclusion under Code section 2036(a)(1).

As discussed in Section III.B.5 above, the date of transfer is the time for determining whether the transferor retained sufficient rights in the transferred property to trigger Code section 2036(a)(1). This strategy entails searching for evidence that the transferor implicitly retained those rights at that time, not attempting to create evidence of a retained interest after the fact.

a. Income tax considerations

No income tax consequences should result from a mere audit of the handling of the transferred assets or a conclusion that, at death, Code section 2036(a)(1) will cause inclusion. If section 2036(a)(1) applies, the transferred assets included in the settlor's estate will receive an new income tax basis.

b. Transfer tax considerations

The settlor may have made a taxable gift when he made the original transfer. If so, that taxable gift should not count as an adjusted taxable gift for purposes of computing the estate tax on the settlor's estate if it is brought back into his estate under Code section

2036(a)(1).[131] Also, if the settlor (or his spouse, in the case of gift-splitting) paid any gift tax as a result of the original transfer, the settlor's estate tax may be reduced by some or all of that gift tax.[132]

c. Fiduciary duties

Unlike the situation described in Section III.B.5.b above, under these facts the client gifted assets outright, instead of in trust. Consequently, it is unlikely that a fiduciary relationship exists.

d. Administrative issues

The transferor's gross estate will include the transferred assets. However, if the transferor's estate is less than $5.43 million, an estate tax return may not be required. Counsel should communicate to the beneficiaries and the personal representative about any facts that may support inclusion under Code section 2036.

If an estate tax return has been filed and did not include the transferred property in the gross estate, could a beneficiary take the position that Code section 2036 inclusion applied and therefore the transferred asset was entitled to a basis adjustment? Current law may not bind a beneficiary (who does not sign the estate tax return) with respect to the date of death value of an inherited asset.[133] Query, is the same dissonance present with respect to whether the asset is or is not included in a taxpayer's gross estate?

e. Creditor and marital issues

If the settlor expressly or impliedly retained an interest in the transferred assets, that interest may be available to his creditors or to a spouse upon divorce. Note that, as in other cases, there may be a tension between the settlor's tax and non-tax objectives. Claiming a retained interest may achieve a tax objective but only at the risk of losing a non-tax objective.

VII. Changing ownership of spousal assets to achieve a new income tax basis for appreciated assets and to preserve the income tax basis of "loss assets"

A. When the strategy is useful

Changing the ownership of marital property can achieve income tax benefits without incurring estate tax costs. Spouses may be able to maximize the step-up in basis for their appreciated assets while avoiding a step-down in basis for their depreciated assets. If the marriage is stable, this strategy may be useful in a variety of situations. For example, planning may be beneficial:

- If the spouses' combined assets are less than the post-ATRA combined applicable exclusion amount;

- If one spouse has significant assets but the other spouse has few; or

- If one spouse has a shortened life expectancy.

Spouses in both community property jurisdictions and common law jurisdictions can take advantage of this strategy, although the available techniques differ in some respects.

Note that this strategy was useful prior to ATRA; ATRA's greater estate tax exclusions and increased income tax rates simply make it more valuable.

B. Implementing the strategy

1. Spouses exchange assets, with appreciated assets received by spouse with a shortened life expectancy while full basis assets and loss assets are received by other spouse

Assume that both spouses own assets (including appreciated assets, depreciated assets, and assets whose basis is roughly equal to fair market value) and that one spouse has a shortened life expectancy. The spouses could exchange assets between them so that:

- The spouse with the shortened life expectancy receives appreciated assets; and

- The other spouse receives depreciated assets and assets with no gain or loss.

As a result, at the infirm spouse's earlier death:

- The income tax basis of the appreciated assets would increase to fair market value, avoiding gain on the sale of those assets; and

- The income tax basis of the depreciated assets would not decrease to fair market value (because those assets are not included in the deceased spouse's gross estate), minimizing any potential taxable gain upon the future sale of the assets by the surviving spouse.

Predicting which spouse will be the first to die cannot be done with certainty. Counsel should clearly advise clients of the potential adverse tax consequences resulting from an unexpected order of deaths.

a. Income tax considerations

The transaction changes the owner of the assets for income tax purposes. This result should make no difference if the spouses file a joint return but it could be important if they file separate returns.

There should be no recognition of gain or loss on the transfer of assets between spouses.[134] The transfer is treated as a gift and the basis of transferred property in the hands of the transferee spouse is its adjusted basis in the hands of the transferor spouse.[135]

If the transferee spouse dies within one year after the transaction and the transferred property passes back to the transferor spouse, the transferor's basis will be the same as the transferee's basis immediately before his death.[136] Arguably, the property will receive a new basis at death even if the donee dies within one year of the transfer if the donee leaves it to a bypass trust for the donor spouse rather than to the donor outright. On its face, it appears that Code section 1014(e) would not apply if the property passes to a bypass trust for the benefit of the donor, particularly if the distribution provisions are purely discretionary.[137] However, a mandatory distribution standard would create an income interest in the surviving spouse, which might prevent a new income tax basis to the extent of the income interest.

See the additional discussion of this issue in Section V.B.1.a above.

b. Transfer tax considerations

A gift will result if one spouse receives property worth more than that received by the other spouse in the exchange transaction. However, the gift should not be taxable as a result of the marital deduction.[138]

c. Fiduciary duties

In some states at least, the relationship that exists between a husband and a wife has been held to create a fiduciary duty requiring the utmost good faith.[139] Hence, any exchange of assets must be consistent with that duty in those states.

d. Administrative issues

State law may govern the formalities of a partition, exchange, or other marital property agreement between spouses.[140] If so, it should be consulted and followed.

e. Creditor and marital issues

The exchange will change the assets that are owned by each spouse, thereby affecting the assets that are available to each spouse's creditors and the rights of the spouses in those assets if they divorce. In some states, the agreement may be void as to preexisting creditors.[141]

2. Spouses living in a community property state can partition community assets with appreciated assets received by spouse with a shortened life expectancy while full basis assets and loss assets are received by other spouse

In a community property state, with respect to most assets, at the death of a spouse, both halves of the community property receive a new income tax basis equal to the then fair market value of the property. This basis adjustment applies notwithstanding the fact that only one-half of the community property is included in the estate of the spouse who died. For appreciated property, this result is often referred to as a "double step-up in basis."

Separate property, on the other hand, receives a new income tax basis only on the death of the spouse who owns such separate property.

If the spouses own community property (including appreciated assets, depreciated assets, and assets whose basis is roughly equal to fair market value) and one spouse has a shortened life expectancy, consider partitioning the community property so that:

- The spouse with the shortened life expectancy receives appreciated assets; and
- The other spouse receives depreciated assets and assets with no gain or loss.

As a result, at the infirm spouse's earlier death:

- The income tax basis of the appreciated assets would increase to fair market value, avoiding gain on the sale of those assets; and
- The income tax basis of the depreciated assets would not decrease to fair market value (because those assets are not included in the deceased spouse's gross estate), ensuring that a future sale by the surviving spouse will more likely result in a loss than a gain.

This approach is better than simply having all assets treated as community property because the spouses can avoid a step-down in basis for loss assets.

Alternatively, to mitigate the risk attendant to the order of deaths, the spouses could allow appreciated community property to remain community while transferring depreciated assets to the spouse with the longer life expectancy. This would at least guarantee that appreciated assets receive a step-up in basis at the death of either spouse.

a. Income tax considerations

See VII.B.1.a above. Additionally, if spouses file joint income tax returns, partnerships or LLCs owned entirely as community property are disregarded for federal income tax purposes. Thus, the partnership or LLC would not be required to file separate income tax returns. In contrast, if the partnership or LLC is owned as separate property, the partnership or LLC would not be a disregarded entity and would be required to file separate income tax returns.

b. Transfer tax considerations

A gift will result if one spouse receives property worth more than that received by the other spouse in the exchange transaction. However, the gift should not be taxable as a result of the marital deduction.[142]

c. Fiduciary duties

In some states at least, the relationship that exists between a husband and a wife has been held to create a fiduciary duty requiring the utmost good faith.[143] Hence, any exchange of assets must be consistent with that duty in those states.

d. Administrative issues

State law may govern the formalities of a partition, exchange, or other marital property agreement between spouses.[144] If so, it should be consulted and followed.

e. Creditor and marital issues

The exchange will change the assets that are owned by each spouse, thereby affecting the assets that are available to each spouse's creditors and the rights of the spouses in those assets if they divorce. In some states, the agreement may be void as to preexisting creditors.[145]

3. Spouses who live in a community property jurisdiction can convert separate property assets into community property

Assume spouses live in a community property state but each owns appreciated separate property. When one spouse dies, his or her separate property will receive a new basis but the separate property of the other will not.

Some states allow spouses by agreement to convert separate property into community property.[146] If they do, then regardless of which spouse dies first all of the appreciated and now-community assets should receive a new income tax basis.[147]

a. Income tax considerations

See VII.B.1.a above.

If spouses are converting property they own as tenants in common to community property, Code section 1014(e) should not apply. Each spouse owned an undivided one-half interest in the property both before the conversion and after the conversion, so the conversion should not result in a transfer of property between them. They are simply changing the legal attributes of their existing co-ownership.[148]

However, if the spouses are converting separate properties, some owned entirely by one spouse and some owned entirely by the other, to community property, the application of Code section 1014(e) to this transaction is uncertain. An example will explain.

<u>Example</u>: *Assume Husband owns Blackacre as his separate property, and Wife owns Whiteacre as her separate property. Both Blackacre and Whiteacre have a basis of $50 and a fair market value of $100. Husband and Wife enter into an agreement converting both Blackacre and Whiteacre to community property. Husband dies within one year*

after the transaction and devises all of his interest in both Blackacre and Whiteacre to Wife. At Husband's death, each tract is still worth $100.

What is Wife's basis in Blackacre and Whiteacre? The literal terms of Code section 1014(e) suggest this result:

- *Husband owned his undivided one-half interest in Blackacre before the transaction. He did not receive it by transfer from Wife. Thus, Code section 1014(e) does not apply to Blackacre at all. Wife's basis in both halves of Blackacre increases as a result of Husband's death, and her basis in the entire tract is $100.*

- *Wife owned her undivided one-half interest in Whiteacre before the transaction and did not transfer it to Husband. The fair market value of Wife's undivided one-half interest receives a new basis at Husband's death equal to its fair market value (presumably $50, but this may be open to debate).*

- *The only property that Wife transferred to Husband in a transaction treated as a gift under Code section 1014*[149] *is Husband's undivided one-half interest in Whiteacre. Code section 1014(e) may apply to this undivided one-half interest, with the result that its basis is $25.*

b. Transfer tax considerations

A gift will result if one spouse receives property worth more than that received by the other spouse in the exchange transaction. However, the gift should not be taxable as a result of the marital deduction.[150]

c. Fiduciary duties

In some states at least, the relationship that exists between a husband and a wife has been held to create a fiduciary duty requiring the utmost good faith.[151] Hence, any exchange of assets must be consistent with that duty in those states.

d. Administrative issues

State law may govern the formalities of a conversion agreement between spouses.[152] If so, it should be consulted and followed.

e. Creditor and marital issues

Converting a spouse's separate property into community property may subject it to claims of the other spouse's creditors when it would not have been subject to those claims had it remained separate property.[153] Also, upon divorce a judge may have greater latitude to divide community property than separate property.[154] State law may preserve the rights of preexisting creditors in the property converted to community property.[155]

4. Spouses who live in a common-law state can attempt to cause appreciated assets to be considered community property

Couples who live in a common law jurisdiction who want all or part of their property to become community property can create an Alaska Community Property Trust or a Tennessee Community Property Trust and contribute property to that trust, which is irrevocable unless the trust instrument provides otherwise. Generally, Community Property Trusts will require a trustee who resides in Alaska or Tennessee, respectively, and administration of the trust to be located in such state. If properly established and administered, the property in the trust will be community property and will be owned one-half by each spouse.[156]

Alternatively, a couple may enter a premarital or post marital agreement that contains a "choice of law" clause, selecting the law of a community property state.[157] Under Restatement (Second) of Conflicts of Law § 258, spouses can agree on the local law applicable to their marital agreement, but it is rare for couples to adopt a law other than that of their domicile state.

Finally, a few common law states may allow their residents to opt-in to a community property regime.

a. Income tax considerations

See Section VII.B.3.a above for a discussion of Code section 1014(e). If the property that was converted to community property received a double basis adjustment (discussed in Section VII.B.4.b below), the surviving spouse will likely save income taxes when the property is sold due to the higher basis.

b. Transfer tax considerations

When a spouse dies, one-half of the property held in the Community Property Trust will be subject to that spouse's disposition. Code section 1014(b)(6) provides that the entire property that is community property under the law of any state receives a new basis on the death of a spouse. This increase is referred to as the double adjustment to basis and should apply to all assets in the Community Property Trust. In a common law jurisdiction, only the decedent's property obtains a step up in basis. *See also* discussion in Section VII.B.1.b above.

c. Fiduciary duties

Spouses owe fiduciary duties to each other with respect to creation of and contributions to a Community Property Trust. Contributing assets to a Community Property Trust will change each spouse's rights in the property contributed, with one spouse giving up rights and the other receiving rights that he or she did not have before the contribution. If spouses give equal assets with a similar income tax basis, they may generally own the same value of property as before, but in different assets. If one spouse contributes

substantially all of the assets to a Community Property Trust (or transfers high basis assets while the other spouse transfers low basis assets), then that spouse is giving up more rights and the other spouse is receiving more rights in the contributed property. The spouses need to be fully informed of the effect of the contribution on their ownership of assets.

d. Administrative issues

Alaska state laws govern the formation of an Alaska Community Property Trust, and Tennessee state laws govern the formation of a Tennessee Community Property Trust. The couple would need to consider the additional trustee fees they could incur and the fact that they would no longer manage the property contributed to the Community Property Trust.

e. Creditor and marital issues

Converting a spouse's separate property into community property may subject it to claims of the other spouse's creditors when it would not have been subject to those claims had it remained separate property.[158] Also, upon divorce a judge may have greater latitude to divide community property than separate property.[159] State law may preserve the rights of preexisting creditors in the property converted to community property.[160] Generally, the law of the spouses' domicile will govern the rights of creditors, and this law will vary state by state. Community Property Trusts affect the nature of the ownership of property and may affect how the law of the domicile applies to that property. Creditors are generally in the same position in states allowing joint tenancies, but may be in a stronger position in states that allow tenancies by the entireties.

5. Wealthy spouse gives appreciated assets to impecunious spouse with shortened life expectancy to achieve new basis at donee spouse's death

This is a simple transaction. It was useful before ATRA; it may be even more useful after ATRA in light of the increased basic exclusion amount.

Assume that one spouse owns a significant amount of assets and that the other spouse owns a nominal amount of assets and has a shortened life expectancy. The wealthy spouse could gift appreciated assets to the poorer spouse so that the wealthier spouse’s assets will be included in the poorer spouse's gross estate and eligible for a basis adjustment upon death. Upon the poorer spouse's death, the assets could return to the wealthy spouse with a new income tax basis, available for sale without capital gain tax.

The same result could be achieved by transferring the assets to a trust for the poorer spouse's benefit and in which the poorer spouse has a general power of appointment.[161]

a. Income tax considerations

The transaction changes the identity of the taxpayer with respect to income on the transferred assets during the poorer spouse's lifetime. Also, if the poorer spouse dies within one year of the transfer and the assets are returned to the donor spouse, Code section 1014(e) will preclude an increased basis for appreciated assets. However, if the poorer spouse dies within one year of the transfer and directs the property to a bypass trust, arguably the assets will qualify for a basis adjustment. *See* discussion in Section VII.B.1.a above.

b. Transfer tax considerations

Assuming the wealthy spouse transfers the appreciated assets either outright to the poorer spouse or to a qualifying trust for the poorer spouse, the gift tax marital deduction should prevent gift tax on the transfer.[162] Because the GST exemption is not portable, this technique may also facilitate the use of the poorer spouse's GST exemption.

c. Fiduciary duties

This transaction would not appear to implicate any fiduciary duties that the spouses may owe to one another.

d. Administrative issues

The wealthy spouse may need to file a gift tax return if the transfer is to a trust for the benefit of the poorer spouse.

e. Creditor and marital issues

This transfer, if made outright, may subject assets to claims of the poorer spouse's creditors.

VIII. Avoiding imposition of the 3.8% NIIT

A. When the strategy is useful

Effective for tax years beginning after December 31, 2012, Code section 1411 imposes a 3.8% tax on certain net investment income ("NII") of individuals, trusts and estates that have income in excess of applicable threshold levels.

Individual taxpayers pay the NIIT on the lesser of the taxpayer's NII for the taxable year or the amount by which the taxpayer's "modified adjusted gross income" ("MAGI") for the taxable year exceeds the applicable threshold amount. The threshold amounts are $250,000 for a married couple filing jointly and $200,000 for a single individual.[163] These threshold amounts are not adjusted for inflation.

Trusts and estates pay the NIIT on the lesser of undistributed NII ("UNII") or adjusted gross income ("AGI") in excess of the highest federal income tax bracket threshold for trusts and estates ($12,300 in 2015). The threshold amount for trusts and estates is adjusted for inflation.

This 3.8% NIIT is especially relevant to trusts and estates since the AGI threshold amount is only $12,300 for 2015. While most individual taxpayers are not impacted by the NIIT, due to the much higher MAGI threshold amounts, trusts and estates are much more likely to be subject to the NIIT. Therefore an important strategy is to identify methods of reducing or eliminating a trust's UNII.

While a summary of certain aspects of the NIIT is included below, a comprehensive review of the NIIT is beyond the scope of this paper.[164]

a. Trusts not subject to NIIT

Grantor trusts are disregarded for purposes of the NIIT. Rather, the NIIT is computed in the same manner as for individuals, and NII is treated as if it had been paid directly to the grantor.[165]

The NIIT does not apply to trusts in which all of the unexpired interests of the trust are devoted to certain charitable purposes, trusts exempt from tax under Code section 501(c), charitable remainder trusts (although annuity and unitrust distributions may be NII to non-charitable recipients), and any other trust fund or account that is exempt from taxes imposed under subtitle A or foreign trusts (except certain foreign trusts with U.S. beneficiaries).[166]

b. Net investment income

"Net investment income" means the excess (if any) of the sum of the following three major types of income, offset by certain permissible deductions:

- **Specified income:** Gross income from interest, dividends, annuities, royalties and rents, except those derived in the ordinary course of a trade or business that is neither a passive activity with respect to the taxpayer, nor a trade or business of trading in financial instruments or commodities.

- **Covered business income:** Other gross income derived from a trade or business that is a passive activity (as defined in Code section 469) with respect to the taxpayer or a trade or business of trading in financial instruments or commodities.

- **Covered gain:** Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the NIIT does not apply.[167]

Certain types of income are specifically excluded from NII, including (i) non-passive trade or business income, (ii) distributions from IRAs and qualified plans, (iii) tax-exempt income and tax-exempt annuities, and (iv) income subject to self-employment tax.[168]

c. Non-passive business income

While income generated by a trade or business that is considered "passive" is subject to the NIIT, income generated by a trade or business in which the taxpayer "materially participates" is not.[169] Code section 469(h)(1) defines material participation as an activity in which the taxpayer participates on a "regular, continuous, and substantial basis."

Individuals will be considered to materially participate, and thus avoid passive income treatment, if they satisfy one of seven tests.[170] Additionally, there is a separate exception for certain real estate professionals.[171]

It is not clear how to determine whether a trust materially participates in a trade or business. Treasury regulations under Code sections 469 and 1411 provide no guidance. The IRS has ruled that a trust may materially participate in a business activity only if the trustee is directly involved in operations of the entity's activities on a regular, continuous, and substantial basis.[172] Further, the IRS has stated that only the trustee's direct actions as a fiduciary, and not as an employee of the business, should be considered in determining whether a trust materially participates in an activity.[173]

The courts have been more taxpayer-friendly in determining whether a trust materially participates in a business. In *Mattie K. Carter Trust v. Commissioner*,[174] the court considered whether the trustee of a trust holding an operating ranch business materially participated in the business. The Carter trust operated its ranch business directly using employees and agents of the trust, rather than through an entity owned by the trust. The court held that material participation of a trust is determined by the activities of those conducting operations on behalf of the trust and allowed the trust to include the actions of the trust's agents and employees, not just the actions of the trustee, in determining material participation.

In *Frank Aragona Trust v. Commissioner*,[175] the Tax Court held that the material participation requirement was met when three out of six individual trustees were actively involved in the business activity. Since state law provided that a trustee could not ignore its fiduciary duties while acting in another capacity (*e.g.*, employee), the activities of the trustee employees were held to be relevant in determining whether the trust materially participated. At a minimum, the ruling suggests that material participation can be satisfied with less than a majority of trustees actively involved in the business activity. The court did not specifically decide whether a trust can include activities of its non-trustee employees in determining material participation, nor did it provide guidelines for trusts and estates on material participation in the context of a corporate trustee or with respect to satisfying Code section 469(h)(1)'s standard of involvement in an activity on a regular, continuous, and substantial basis.[176]

B. Implementing the strategy

1. Change the trustee to an individual who is active in the business operations

Trusts are often funded with an interest in an operating business. However, if the trustee is not actively involved in the business, the trust's income generated by the business will be considered passive and subject to the 3.8% NIIT. If a trust owns an interest in an operating business and the trustee is not actively involved in its operation such that the trust may not satisfy the material participation test, consider adding a co-trustee or replacing the sole trustee with an individual who is actively engaged in operating the business.

<u>Example</u>: *Husband died owning a farm that was distributed to Wife as sole trustee of a bypass trust. While Wife is not active in the farm operations, Child is. Wife could either appoint Child as a co-trustee or resign and appoint Child as the sole trustee. While the Mattie Carter and Frank Aragona decisions do not clearly define what is required for a trust to materially participate, Child serving as trustee will provide additional support that the bypass trust's income generated by the farm is not subject to the NIIT.*

The IRS has taken the position that the appointment of an individual who is active in the business as a "special trustee" with only limited authority to act will not satisfy the material participation test.[177] Therefore it will be important for the newly appointed trustee to have full trust powers.

a. Income tax considerations

If the appointed trustee satisfies the material participation test, the trust's business income will be excluded from NII and therefore will not be subject to the NIIT. Overall, the amount of income tax paid by the trust will be reduced.

Ensure that the trustee reports the business income as non-passive income on the trust's income tax return to trigger the statute of limitations.

b. Transfer tax considerations

Assuming that the appointed trustee does not have rights and powers that would cause trust assets to be includible in his gross estate, there should be no federal transfer tax consequences.

c. Fiduciary duties

A trustee who does not meet the material participation requirement should consider whether he has a fiduciary duty to resign and/or appoint additional or successor trustees who may satisfy the material participation test and avoid or minimize the NIIT.

By accepting an appointment, a new trustee assumes fiduciary duties to the beneficiaries of the trust.

d. Administrative issues

Accomplishing the resignation and appointment of additional or successor trustees will require preparation and execution of the resignation and appointment documents. If the trust instrument does not contain the requisite language for resignation and/or additional or successor trustee appointments, court action may be required.

e. Creditor and marital issues

If the appointed trustee is also a beneficiary of the trust, his creditors and his spouse may have greater access to the trust assets to satisfy arising claims, depending upon the terms of the trust and applicable state law.

2. Distribute, sell, or swap the trust-owned business interests so they are held by family members who are active in the business

If it is not feasible or advisable to appoint a trustee who is actively participating in the business, the trustee may want to consider whether it is advisable to distribute, sell, or swap business interests owned by the trust to family members who meet the material participation test.

<u>Example</u>: *Applying the facts in Section VIII.B.1 above, Wife, as trustee, could sell the bypass trust's interest in the farm to Child in exchange for cash and/or a promissory note. If the bypass trust was recently funded or the assets have not appreciated since Husband's death, the sale should result in little or no taxable gain. Future income generated by the farm should be free of the NIIT since Child actively operates the farm. The bypass trust can manage and invest the sale proceeds and make distributions to Wife to minimize potential imposition of the NIIT.*

a. Income tax considerations

The income generated by the business interests that were transferred to family members who are active in the business is excluded from NII.

A distribution, sale, or swap may have income tax consequences. For example, a sale or swap may result in gain to the trust and a distribution may carry out DNI to the beneficiary. The trust and the beneficiary should report the transaction on their respective income tax returns. The family members should report the business interest as non-passive income on their individual income tax returns to trigger the statute of limitations.

b. Transfer tax considerations

The transferred business interests will be included in a family member's gross estate unless transferred or sold during life. A distribution (as opposed to a sale or swap) of a business interest from a trust that is exempt from the GST tax to a non-skip beneficiary could "waste" exempt assets.

c. Fiduciary duties

The trustee must examine the trust instrument to ensure that a distribution, sale, or swap is permissible.

If the business interests have significant appreciation potential and are owned by a transfer tax exempt trust, the trustee will want to consider whether the distribution, sale, or swap is advisable and in the best interests of the beneficiaries.

d. Administrative issues

Any distribution, sale, or swap should be properly documented. The parties should commission an appraisal if the asset to be distributed, sold, or exchanged is hard to value.

e. Creditor and marital issues

Assets that are distributed, sold, or swapped to family members may provide their creditors and spouses greater access to the trust assets to satisfy claims.

3. Convert a grantor trust into a non-grantor trust when the grantor cannot materially participate but the trustee can

As discussed above, grantor trusts are disregarded for purposes of the NIIT. For a grantor trust, the NIIT is computed in the same manner as for individuals, and NII is treated as if it was paid directly to the grantor.[178] The grantor's MAGI threshold ($250,000 for a married couple filing jointly, or $200,000 for a single individual) will apply. Further, the determination of whether the income generated by the grantor trust's interest in a business is "passive" or "active" is made by evaluating the grantor's involvement – not the trustee's.

If a grantor is expected to always have income in excess of the MAGI threshold and does not actively participate in the business owned by the trust, consider converting the grantor trust into a non-grantor trust. If the trustee is actively involved in the business, this change will shift the focus of the material participation test to the trustee and enable income generated by the business to be free of the NIIT. Alternatively, if the trustee is not actively involved in the business, depending upon the terms of the trust instrument, the conversion could facilitate distributions by the trustee to trust beneficiaries whose income is under the MAGI threshold - thus avoiding the NIIT.

a. Income tax considerations

If grantor trust status is terminated, future income tax will be paid by the trust or its beneficiaries. The trustee can make distributions to beneficiaries in an effort to minimize income tax. After grantor trust status is turned off, transactions between the grantor and the trust will be subject to income tax. See further discussion in Section IX.B.1.c below.

b. Transfer tax considerations

Generally, termination of grantor trust status will not have transfer tax consequences. However, the grantor can no longer effectuate a wealth shift by paying the trust's income tax. Assets distributed to beneficiaries will be includible in their gross estates for estate tax purposes unless consumed or given away prior to death. See further discussion in Section IX.B.1.c below.

c. Fiduciary duties

Termination of grantor trust status may or may not implicate fiduciary duties to the beneficiaries, depending on how it is done and who does it. The trustee should adhere to the terms of the trust instrument in deciding whether to make distributions to beneficiaries. See further discussion in Section IX.B.1.c below.

d. Administrative issues

Termination of grantor trust status must be accomplished in accordance with the terms of the trust instrument and the provisions of local law.

e. Creditor and marital issues

Termination of grantor trust status may affect the rights of creditors and spouses depending on how it is done and who does it. Assets distributed to beneficiaries will be available to satisfy claims of their creditors and spouses. See further discussion in Section IX.B.1.c below.

4. Convert a non-grantor trust into a grantor trust when the trustee cannot materially participate but the grantor can

If the trustee of a non-grantor trust cannot satisfy the material participation test but the grantor actively operates the business, consider converting the non-grantor trust into a grantor trust. Since the conversion shifts the focus of the material participation test from the trustee to the grantor who is active, the NIIT is avoided.

Alternatively, if the grantor is not active in the business, but the grantor's personal income combined with the trust's income does not exceed the grantor's MAGI threshold, ($250,000 for a married couple filing jointly, or $200,000 for a single individual), the NIIT is avoided.

a. Income tax considerations

If a trust is converted from a non-grantor trust to a grantor trust, all income gain or loss will be taxed directly to the grantor. Further, transactions between the grantor and the trust will be ignored for income tax purposes.

b. Transfer tax considerations

Conversion to a grantor trust generally will not result in transfer tax consequences. Grantor trust status may enable the grantor to effectuate an additional wealth shift by paying the trust's income tax.

c. Fiduciary duties

If the trustee's action is required to change the grantor trust status, the trustee must act in the best interest of the beneficiaries. Typically conversion to a grantor trust will benefit the trust's beneficiaries since the obligation to pay income tax is shifted away from the trust and its beneficiaries to the grantor.

d. Administrative issues

Conversion to grantor trust status must be accomplished in accordance with the terms of the trust instrument and the provisions of local law. See Section III.B.2 above, for a discussion regarding methods to convert a non-grantor trust into a grantor trust.

e. Creditor and marital issues

Conversion of grantor trust status may affect the rights of creditors and spouses depending on how it is done and who does it.

5. Manage non-grantor trust distributions to beneficiaries whose MAGI will not exceed the NIIT threshold

Trustees have always managed distributions from non-grantor trusts to shift taxability to beneficiaries who are in lower income tax brackets. The 3.8% NIIT is just another reason to consider this type of tax planning.

<u>Example</u>: A non-grantor trust has substantial income in 2015, including income that, if retained by the trust, will be subject to a 39.6% income tax and the 3.8% NIIT. If the trust distributes all of its income in excess of $12,300, to an unmarried beneficiary, whose resulting taxable income is less than $186,350 but more than $89,350, the following will result: (i) the trust will have no UNII and thus no NIIT; and (ii) the assets distributed to the beneficiary will be subject to a 28% income tax and will be exempt from the NIIT. The combined tax rate on the distributed assets will be 28% versus 43.4% - a savings of 15.4%. The tax savings could be even greater, depending on state income taxes.

a. Income tax considerations

Generally, complex trusts and estates (and their beneficiaries) are taxed (as to income) in the following manner: beneficiaries on the portion of the income distributed to them; and trusts or estates on the portion of the income retained. To the extent that a trust or estate distributes NII to its beneficiaries, the NII is passed through to the beneficiaries.[179] If a trust's or estate's retained income will be subject to the 39.6% income tax rate and the 3.8% NIIT, distributing income to beneficiaries whose income will be taxed at lower income tax rates and will be free of the NIIT could result in substantial savings.

The trustee should consider potential state income tax consequences of the trust’s retention or distribution of such income. If the trust is not subject to state income tax but a beneficiary is, the tax savings generated by trust distributions, that reduce federal income tax and avoid the NIIT, could be less than the increased state income tax imposed on the beneficiary.

b. Transfer tax considerations

Assets distributed to beneficiaries will be included in their gross estates for estate tax purposes unless consumed or transferred prior to death. Additionally, if a trust is exempt from GST tax, distributions to a non-skip beneficiary may "waste" exempt assets.

c. Fiduciary duties

The trustee must examine the standard for distribution set forth in the trust instrument and evaluate the extent to which tax considerations come into play with respect to trust distributions. If the distribution standard is based solely on the health, education, maintenance, and support of the beneficiary, the trustee may not have authority to take the tax effect of distributions into consideration.

d. Administrative issues

Distributions to beneficiaries will shift the burden of taxation. The parties should ensure that all reporting requirements of Forms 1040 and 1041 are satisfied.

The trustee may make trust distributions to a beneficiary during the first 65 days after the end of the taxable year and treat the distributions as if they were made on the last day of the prior year.[180] Since a trust's or estate's taxable income may not be determined by year end, the 65-day rule[181] may be helpful in planning distributions to carry out income to beneficiaries with higher thresholds. The 65-day rule applies to both income tax and the NIIT.

e. Creditor and marital issues

Assets distributed to beneficiaries will be available to satisfy claims of their creditors and spouses.

IX. Addressing life insurance policies and life insurance trusts that are no longer needed

A. When the strategy is useful

Historically, life insurance has been an important financial product utilized by clients to provide liquidity to pay estate tax. After ATRA, however, there may be little need for many existing policies due to the higher basic exclusion amount, along with the portability of a deceased spouse's unused exclusion amount. Consequently, whether such a life insurance policy is owned by the insured, by an irrevocable life insurance trust ("ILIT"), or directly by the insured's intended beneficiaries, it may no longer be desirable to keep such policy in force, particularly if the insured has grown tired of ILIT formalities or if the policy has failed to live up to investment expectations.

B. Implementing the strategy

1. Surrender the policy (by the insured, ILIT, or other owner)

If a policy's death benefit is no longer needed to help pay estate tax or is no longer justifiable in light of the ongoing premiums, the owner may be able to surrender the policy to the issuing insurance company. Likewise, the trustee of an ILIT may consider surrendering a policy if the death benefit is no longer needed, the ILIT lacks sufficient funding to pay future premiums, or the cash surrender value could be more prudently invested for the benefit of the beneficiaries.

a. Income tax considerations

With certain exceptions, such as when the insured is terminally ill,[182] if an owner surrenders a policy, the owner will recognize ordinary income to the extent that the amount received from the insurance company exceeds the owner's basis in the policy.[183] Generally, the owner's basis is equal to the total amount of premiums paid by the owner, reduced by any untaxed amounts, such as dividends, that the owner has withdrawn from the policy.[184]

b. Transfer tax considerations

Surrendering a life insurance policy merely involves the exchange of one asset (the policy) for another (the cash surrender value of the policy). Thus, the transfer tax consequences are fairly straightforward. In the case of individual ownership, instead of the death benefit (reduced by any future premiums paid) being included in the owner's gross estate, the cash received by the owner (plus any reinvestment or appreciation) will be included in the owner's gross estate. Note, however, that because an ILIT is designed to exclude the death benefit from the insured's gross estate, if an ILIT surrenders a policy, the cash surrender value should also be excluded from the insured's gross estate, unless, of course, the ILIT is terminated and distributed back to the insured or to one or more of the beneficiaries.

c. Fiduciary duties

An individual owner of a policy does not owe a fiduciary duty to the named beneficiaries or others. In contrast, a trustee of an ILIT owes fiduciary duties to the ILIT's beneficiaries, including the duty to invest the trust assets in a reasonably prudent manner. Consequently, prior to surrendering a policy owned by an ILIT, the trustee should consider whether the surrender and subsequent reinvestment of the cash surrender value would constitute a prudent investment in the best interests of the ILIT's beneficiaries.

d. Administrative issues

The exact process by which an owner may surrender a life insurance policy will largely be dictated by the insurance company that issued the policy. Thus, the owner will work with the insurance company to determine the cash surrender value of the policy and the procedures by which the policy may be surrendered.

e. Creditor and marital issues

In many states, a life insurance policy payable to an insured or a beneficiary, including its cash surrender value, is exempt from creditors' claims.[185] Consequently, prior to surrendering a policy, individual owners should carefully consider the potential impact of giving up the creditor protection associated with the policy under applicable state law.

2. Sell the policy to a third party

In certain circumstances, selling a life insurance policy to a third party may generate a greater return than surrendering the policy to the insurance company. Like most things, a life insurance policy is worth as much as a third party is willing to pay for it. Market prices can be affected by a wide variety of factors, including the insured's age, health, and life expectancy, as well as the terms and features of the policy.[186]

a. Income tax considerations

The sale of a life insurance policy is subject to the usual provisions of Code section 1001, with the owner recognizing gain or loss on the sale.[187] As explained in Section IX.B.1.a above, when an owner surrenders a policy to the insurance company, the owner's income tax basis in the policy is equal to the total amount of premiums paid by the owner, reduced by any untaxed amounts, such as dividends, that the owner has withdrawn from the policy. When an owner sells a policy to a third party, however, the owner's income tax basis must be reduced by the portion of premiums paid that are attributable to the "cost of insurance."[188] If a policy is sold for more than its cash surrender value, therefore, the owner has (i) a tax-free return of capital up to the premiums paid, less the cost of insurance, (ii) ordinary income thereafter up to the cash surrender value, and (iii) capital gains for any excess amount received. In the case of term policies, the cost of insurance is generally presumed to be equal to the premiums paid, so the entire sales proceeds are generally treated as capital gains.[189]

For example, in Revenue Ruling 2009-13, Situation 2, the insured paid premiums equal to $64,000, with $10,000 attributable to the cost of insurance. The insured had not received any tax-free distributions from the policy. The cash surrender value of the policy was $78,000, and the insured sold the policy to a third party for $80,000. The Service ruled that the owner's tax basis in the policy was $54,000, which was equal to the premiums paid ($64,000) minus the cost of insurance ($10,000). On the sale, the owner had an income tax gain of $26,000 ($80,000 realized minus $54,000 basis). The first $14,000 was ordinary income, which was equal to the cash surrender value of the policy ($78,000) minus the total premiums paid ($64,000). The remaining $12,000 was capital gain.[190]

b. Transfer tax considerations

Selling a life insurance policy for fair market value should not be a gift. Consequently, such a sale should simply involve the exchange of one asset (the policy) for another asset (the consideration), both of which may be subject to estate tax in an individual owner's hands, as discussed in Section IX.B.1.b above. Selling a life insurance policy for less than fair market value, however, would result in a gift to the purchaser equal to the fair market value of the policy minus the consideration paid.[191]

c. Fiduciary duties

An individual owner of a policy does not owe a fiduciary duty to the named beneficiaries or others. In contrast, a trustee of an ILIT owes fiduciary duties to the ILIT's beneficiaries, including the duty to invest the trust assets in a reasonably prudent manner. Consequently, prior to surrendering a policy owned by an ILIT, the trustee should consider whether the surrender and subsequent reinvestment of the cash surrender value would constitute a prudent investment in the best interests of the ILIT's beneficiaries.

d. Administrative issues

An owner who wishes to sell a life insurance contract should consider retaining a licensed life settlement broker, who can seek multiple bids for the life insurance contract. Settlement prices will depend on the age, life expectancy, and health of the insured, as well as the terms and age of the policy, and may carry substantial sales commission costs. Once sold, the owner may need to report the sale on his federal income tax return.

e. Creditor and marital issues

In many states, a life insurance policy payable to an insured or a beneficiary, including its cash surrender value, is exempt from creditors' claims.[192] Consequently, prior to surrendering a policy, individual owners should carefully consider the potential impact of giving up the creditor protection associated with the policy under applicable state law.

3. ILIT transfers policy to grantor-insured

In light of ATRA, it may no longer make sense to retain a life insurance policy inside an ILIT. Either the ILIT is no longer needed to save estate taxes, or the grantor no longer wants to keep up with the costs and complexities of the ILIT structure. The grantor can acquire the policy from the ILIT, and thus simplify the ownership and maintenance of the policy, by purchasing the policy for fair market value or, if the ILIT contains a swap power, exercising the swap power by substituting assets of an equivalent value.

a. Income tax considerations

If the ILIT is a grantor trust, the sale of the policy to the grantor-insured for fair market value is not a recognized as a sale for federal income tax purposes.[193] Thus, the ILIT will not recognize any gain on the sale and the grantor-insured will take the ILIT's basis in the policy.[194] Similarly, if the ILIT provides the grantor-insured a swap power, the grantor could acquire the policy for other property of an equivalent value without income tax consequences. If the ILIT is not a grantor trust, the sale will be reported for federal income tax purposes as discussed in Section IX.B.2.a above.

Although insurance proceeds are generally delivered income-tax free to the recipient, it is important to note that the "transfer-for-value" rule may apply any time a life insurance policy is transferred for valuable consideration.[195] Under the transfer-for-value rule, unless an exception applies, the death benefit is excludable from gross income only to the extent of the consideration paid to acquire the policy, plus any premiums subsequently paid by the purchaser.[196] In other words, a substantial portion of the death benefit could be taxed as ordinary income. Note that the transfer-for-value rule does not apply if the purchaser is the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder of officer.[197] The transfer-for-value rule also does not apply if the transferee receives the policy with a carryover basis (*e.g.*, by gift).[198] As a result of these exceptions, if the grantor-insured purchases the policy from the ILIT, the transfer-for-value rule should not apply.

b. Transfer tax considerations

The primary purpose of structuring an ILIT to own insurance on the grantor's life is to exclude the death benefit from the grantor's gross estate. The grantor-insured's acquisition of the policy, therefore, will bring the death benefit back into the grantor's gross estate, although the grantor's gross estate will no longer include any consideration paid to the ILIT or any assets swapped with the ILIT. Given the facts of our scenario (*i.e.*, the ILIT no longer makes sense), this should not be a major concern.

c. Fiduciary duties

The trustee of the ILIT has a fiduciary duty to act in the best interests of the beneficiaries. This duty necessarily includes obtaining fair market value if the policy is sold or ensuring that the ILIT receives assets of an equivalent value in a swap. To determine the fair

market value of the policy, or any hard-to-value assets received in exchange, the trustee may need to obtain one or more third-party appraisals.

d. Administrative issues

Assuming the ILIT is a grantor trust, neither a fair market sale nor a fair market swap will create income or transfer tax reporting obligations. Nevertheless, it is important to document the sale or swap with a purchase agreement or a swap agreement, as appropriate, and, as discussed above, to confirm the value of any hard-to-value assets, including the policy, if necessary. Moreover, especially if hard-to-value assets are involved, the grantor-insured may consider filing a federal gift tax return reporting the sale or the swap, but taking the position that the transfer was not a gift because the consideration paid or assets substituted were of equivalent value. So long as the transfer is adequately disclosed, this filing should trigger the Service's three-year statute of limitations to challenge the tax-free nature of the reported transfer.

e. Creditor and marital issues

Whenever assets are transferred from a trust to an individual, the assets lose the creditor protection benefits associated with the trust form of ownership. Despite this fact, insurance policies themselves often receive some measure of creditor protection under state law,[199] and because the transfer is merely an exchange of equivalently-valued assets, the potential loss of creditor protection benefits would be minimal, if any, at least during the grantor-insured's lifetime.

X. Turning off grantor trust status to avoid unnecessary wealth shifts and to facilitate income tax planning

A. When the strategy is useful

Many clients have incorporated grantor trusts[200] into their estate plans. The most prominent tax advantages of a grantor trust are:

- Since transactions between the grantor and the trust are essentially transactions between the grantor and himself, those transactions do not have income tax consequences (*e.g.*, no capital gain on sale of appreciated assets and no ordinary income on interest payments). Therefore, grantor trust status enables the grantor and the trust to purchase and sell assets, swap assets, and borrow and lend funds between them with no income tax consequences.

- The grantor's payment of tax on the trust's income represents a discharge of the grantor's own liability and not a discharge of the trust's liability. Hence, there is no gift tax result, assuming the trust instrument does not require the trustee to reimburse the grantor for income tax payments.

> Payment of tax on the trust's income is, to that extent, a way to augment the trust's assets outside the transfer tax system.[201]

After ATRA, some clients may decide that they no longer need the benefits of grantor trust status for their previously-created trusts.

- ATRA's increased income tax rates impose a greater financial burden on the grantor for paying income tax on trust income while simultaneously reducing the gift tax impetus for the grantor to do so. It may be possible to reduce overall family income taxes by imposing the tax liability for trust income on either the trust (if not distributed) or the beneficiaries (through distributions).

- So long as the trust is a grantor trust, the grantor's payment of the trust's income tax liability will consume assets that might otherwise have received an estate tax-free step-up in basis at his death (that is, the grantor's own assets) rather than trust assets that will receive no basis step-up.

For those clients, turning off grantor trust status and converting the trust to a separate taxpayer is a useful strategy.

However, a few words of caution about this strategy are also in order:

- A number of the strategies previously suggested in this paper depend upon a trust being a grantor trust when the strategy is implemented. If the client intends to employ those strategies, then obviously he should not turn off grantor trust status before he does so.

- If the grantor trust participated in an installment sale transaction with the client, be sure that the note has been paid before the conversion in order to avoid recognition of gain on the conversion and taxable income from interest payments after the conversion.

- Termination of grantor status with respect to a trust that owns assets with debt in excess of income tax basis will result in immediate recognition of income.

These issues are discussed in greater detail below.

B. Implementing the strategy

In many cases it will be possible to turn off grantor trust status and cause the trust to be treated as a separate taxpayer and taxed on its own income. The mechanism for doing so and the cost to the grantor depend on the particular trust provision that creates grantor

trust status in the first place. Below we consider some of the most frequent bases for grantor trust status and the options for avoiding them.

1. Release swap power

Code section 675(4)(C) provides that the grantor will be treated as the owner of any portion of a trust as to which any person, acting in a non-fiduciary capacity and without the consent of anyone in a fiduciary capacity, has the power to reacquire trust assets by substituting other property of an equivalent value. This is typically called a "swap power." If grantor trust status results from a swap power, the holder of the power must release it in order to turn off grantor trust status.

a. Income tax considerations

One income tax consideration is obvious. Turning off grantor trust status, whether by releasing a swap power or otherwise, will change the identity of the taxpayer who is liable for income tax on trust income. The grantor will no longer be liable; rather, the trust will be liable as a separate taxpayer, and the burden of income tax will ultimately fall, directly or indirectly, on the beneficiaries of the trust.

Other income tax considerations may not be so obvious. First, after grantor trust status is turned off, any transaction between the grantor and the trust will be subject to income tax, just like any other transaction between different taxpayers. Hence, if the grantor sells appreciated assets to the trust for cash or a promissory note, the grantor will recognize capital gain. And if the trust pays interest to the grantor, the interest will be taxable to the grantor as ordinary income. Neither transaction would have been taxable if the trust were a grantor trust.

Second, the IRS treats the termination of grantor trust status during the grantor's lifetime as, in effect, a transfer of trust assets from the grantor to the trust at the time grantor trust status ends.[202] Ordinarily, this will pose no income tax problems because the transfer is not for consideration. However, there are circumstances that can create significant income tax problems. For example, suppose the trust holds a partnership interest and the partnership's debt attributable to that interest is greater than the trust's basis in the interest. The termination of grantor trust status, and the deemed transfer of the partnership interest from the grantor to the trust, will cause the grantor to recognize taxable gain equal to the trust's allocable amount the partnership's debt in excess of its basis. This gain should be capital gain unless there is some recapture taxed as ordinary income. The gain may also be subject to the 3.8% surtax on NII.

Finally, timing the release of a swap power is important. Other post-ATRA strategies involve the grantor swapping his own high-basis assets for low-basis trust assets, thereby achieving a basis step-up at his death that would otherwise be lost, or engaging in purchase and sale transactions with the trust. Obviously, the grantor should not release his swap power until he makes any beneficial swaps or concludes that there are none.

b. Transfer tax considerations

The release of a swap power should have no transfer tax results.

c. Fiduciary duties

A swap power imposes no fiduciary duty on the grantor or other power-holder to either exercise or refrain from exercising the power, or even to retain it. The release of the swap power therefore should not violate any fiduciary duty.

The trustee has a fiduciary duty to ensure that the fair market value of the assets that the power-holder transfers to the trust equals the fair market value of the assets that the power-holder recovers from the trust.

d. Administrative issues

If grantor trust status results from a swap power, the power-holder must release the power. Note that the swap power need not be held by the grantor. Rather, Code section 675(4)(C) provides that the grantor will be treated as the owner of any portion of a trust if "any person," acting in a non-fiduciary capacity and without the consent of anyone acting in a fiduciary capacity, can reacquire the trust corpus by substituting assets of equivalent value. If someone other than the grantor holds the swap power, the grantor must convince that person (and perhaps any successor power-holders) to release the power in order to successfully turn off grantor trust status.

e. Creditor and marital issues

The release of a swap power should not affect the rights of the power-holder's creditors or spouse.

2. Release power to add beneficiaries

Code section 674(a) provides, in general, that the grantor will be treated as the owner of any portion of a trust with respect to which the beneficial enjoyment of principal or income is subject to a power of disposition exercisable by the grantor or a non-adverse party, without the approval or consent of an adverse party. So, in general, if the trustee has discretion to distribute income or principal and the trustee is either the grantor or someone else who is not adverse to the exercise of the distribution power, the trust will be a grantor trust.

Code sections 674(b), (c), and (d) provide exceptions to the general rule. For example:

- Section 674(b)(5) provides that a discretionary power to distribute principal will not create grantor trust status if it is limited by a "reasonably definite ascertainable standard" or if the distribution must be charged only against the share of the trust whose income is distributable to the beneficiary (*e.g.*, a separate trust).

- Section 674(b)(6) provides that a discretionary power to distribute income will not create grantor trust status if any accumulated income must ultimately be paid to the beneficiary from whom it has been withheld, or to his estate, or to his appointees (or takers-in-default) so long as the beneficiary has the broadest possible non-general power of appointment.

- Section 674(b)(7) provides that a discretionary power to distribute or withhold income while the beneficiary is under age 21 or legally disabled will not create grantor trust status.

- Section 674(c) provides that a discretionary power to distribute either income or principal will not create grantor trust status if the power is exercisable solely by an "independent trustee" (that is, a trustee or trustees, none of whom is the grantor and not more than half of whom are related or subordinate parties to the wishes of the grantor).

- Section 674(d) provides that a discretionary power to distribute income will not create grantor trust status if the power is exercisable by a trustee or trustees, none of whom is the grantor or a spouse living with the grantor, and the power is limited by a "reasonably definite external standard."

However, each of the exceptions described above provides that it does not apply if anyone has the power to add to the class of beneficiaries except to provide for after-born or after-adopted children. Practitioners who want to create a grantor trust will sometimes incorporate one or more of the exceptions described above (so that the trust could otherwise qualify as a non-grantor trust), but give an independent power-holder the authority to add beneficiaries (so as to render the exceptions inapplicable and thereby create grantor trust status). If grantor trust status results from such a power, the holder of the power must release it in order to turn off grantor trust status.

a. Income tax considerations

See X.B.1.a above.

b. Transfer tax considerations

The release of a power to add beneficiaries should have no transfer tax results unless the power-holder can add himself (which would be very unusual).

c. Fiduciary duties

Arguably, a power to add beneficiaries should impose no fiduciary duty on the power-holder to either exercise or refrain from exercising the power. In many cases, the trust instrument will expressly exonerate the trustee from any liability associated with the power-holder's addition or non-addition of trust beneficiaries. If this argument holds, the

release of the power should not violate any fiduciary duty. While this power seems fairly straightforward, state law can be uncertain regarding whether power-holders, trust protectors, trust advisors, or other types of trust actors are, in fact, fiduciaries with fiduciary responsibilities. This inquiry becomes even murkier if the power to add beneficiaries is held by an independent trustee. For these reasons, it is important to consult state law whenever considering the release of any power over trust property.

d. Administrative issues

The power-holder must release the power. The trust instrument may specify the procedures for releasing powers in general or the power to add beneficiaries in particular. For example, the trust instrument may provide for release by a signed, acknowledged instrument in writing that is delivered to the trustee. The power-holder should follow the procedures provided in the trust instrument.

e. Creditor and marital issues

The release of a power to add beneficiaries should not affect the rights of the power-holder's creditors or spouse. With respect to a beneficiary, however, releasing the power to add beneficiaries also forfeits any opportunity to diminish the beneficiary's discretionary interest in the trust, which may operate to limit creditors' and spouses' ability to force distributions from the trust.

3. Change trustees

Discretionary distribution powers can cause grantor trust status, as discussed in Section X.B.2 above. However, there are important exceptions.

First, discretionary distribution powers held by independent trustees (*i.e.*, none of whom is the grantor and no more than half of whom are related or subordinate parties who are beholden to the grantor's wishes) generally will not result in grantor trust status.[203]

Second, a discretionary power to distribute principal will not cause grantor trust status if it is limited by a "reasonably definite standard."[204] However, while a discretionary power to distribute income is safe under a number of circumstances,[205] a "reasonably definite external standard," by itself, will make the power safe only if the power is held by a trustee or trustees, none of whom is the grantor or a spouse living with the grantor.[206]

Depending upon the terms of a trust, avoiding or terminating grantor trust status may require a change in trustees so that only an appropriate person holds discretionary distribution powers over income and principal.

<u>*Example*</u>*: Client transfers assets to an irrevocable trust for the benefit of Client's children, grandchildren, or more remote descendants. Client serves as trustee and is permitted to make discretionary distributions of income and principal to any one or more beneficiaries for their health, education, maintenance, and support. Client also has the*

right to remove and replace trustees. None of the beneficiaries possesses a power of appointment over the trust assets.

Pursuant to Code section 674(b)(5), the trust is not a grantor trust with respect to principal because Client's ability to distribute principal is limited by a reasonably definite standard. The trust is a grantor trust with respect to income, however, because Client is trustee and neither of the exceptions in Code section 674(b)(6) or 674(b)(7) applies. To convert the trust from a grantor trust to a non-grantor trust with respect to the trust's income, Client can resign as trustee and release any right to remove and replace trustees with related or subordinate parties, as discussed in Section X.B.4 below.

a. Income tax considerations

See X.B.1.a above.

b. Transfer tax considerations

Assuming a grantor's initial gift to an irrevocable trust was a completed gift for gift tax purposes, there should be no transfer tax consequences to changing trustees to convert a grantor trust to a non-grantor trust. However, depending upon the scope of the discretionary distribution power in the trust instrument, such a power, if retained by the grantor, could prevent the grantor's initial gift to the trust from being complete for gift tax purposes.[207] If the grantor ceases to be the trustee, this may complete the gift and result in a taxable gift at that time.

Also, depending upon its scope, a discretionary distribution power retained by the grantor may cause the trust assets to be included in the grantor's gross estate at death under Code section 2036(a). If the grantor ceases to serve as trustee and, as a result, relinquishes the power, and if the grantor lives for more than three years thereafter, the trust asset should no longer be includible in the grantor's gross estate.[208]

c. Fiduciary duties

Changing trustees may implicate fiduciary duties to the beneficiaries, depending upon how it is done and who does it.

First, assume the trustee wishes to resign, either pursuant to a power in the trust instrument or by asking a court for permission to resign. If the only reason for resigning is to terminate grantor trust status and to shift the income tax burden from the grantor to the beneficiaries, will the trustee breach a fiduciary duty to the beneficiaries by doing so?

If the trust instrument authorizes removal of a trustee without cause and appointment of a successor, presumably the trustee will have no power to prevent his removal. Removal under those circumstances should not violate any fiduciary duty by the trustee. *Query*: Does the power-holder have a fiduciary duty to the beneficiaries? If so, does the power-

holder violate that fiduciary duty by removing a trustee in order to benefit the grantor rather than the beneficiaries?

Alternatively, the trust instrument may allow removal of the trustee only for cause or may be silent regarding removal, thus requiring court action to remove the trustee. *Query*: Does a trustee have a fiduciary duty to oppose his removal if the only reason for removal is to shift the income tax burden from the grantor to the trust and its beneficiaries?

d. Administrative issues

If the trust instrument permits, a change of trustee can be accomplished without court intervention. That is, the trustee can resign or be removed by a person holding the power to remove without cause, and a person holding the appointment power can appoint a successor. *Query*: If a person holds the power to remove the trustee but only for cause, does this authorize removal only to terminate grantor trust status?

Absent authorization in the trust instrument, the trustee's resignation or removal and the appointment of a successor trustee would require court action. *Query*: If the trustee or the beneficiaries object, would a court have grounds for removing a trustee if the only objective is to terminate grantor trust status?

e. Creditor and marital issues

Assuming the trustee has no beneficial interest in the trust, a change in trustees should not affect the rights of the trustee's creditors or spouse. The elimination of grantor trust status should increase the assets available to satisfy claims of the grantor’s spouse or creditors (because it eliminates an income tax obligation the grantor otherwise would have), and decrease the assets available to satisfy claims against the trust or its beneficiaries (because it imposes the income tax liability on them).

4. Relinquish or limit a "revolving door" power

The previous Section (Section X.B.3 above) discussed termination of grantor trust status by changing the identity of the trustee. However, this solution may fail if the grantor has a "revolving door" power, *i.e*. the unfettered power to remove and replace the trustee.

The IRS argues that the holder of a revolving door power has, by attribution, the powers of the trustee. This is because the power-holder can effectively exercise those powers by continuing to remove and replace the trustee until the power-holder finds one who will comply with the power-holder's wishes. Hence, if a discretionary distribution power would cause grantor trust status if held by the grantor, vesting that power in another trustee will accomplish nothing if the grantor has a revolving door power.

The IRS has ruled that a removal and replacement power will not cause attribution of the trustee's powers to the power-holder if the power-holder cannot appoint, as successor trustee, either himself or someone who is "related or subordinate" to him within the

meaning of Code section 672(c).[209] Hence, to avoid grantor trust status, the grantor must either relinquish his revolving door power or partially release it so that it conforms to the IRS's ruling.

a. Income tax considerations

See X.B.1.a above.

b. Transfer tax considerations

A revolving door power may be construed as an "indirect" holding of the trustee's powers. If so, this power implicates the considerations discussed in Section X.B.3.b above.

c. Fiduciary duties

It is unlikely that a grantor-trustee would owe a fiduciary duty to the beneficiaries to retain a revolving door power.

d. Administrative issues

The grantor must adhere to the terms of the trust instrument and the provisions of local law governing the procedure for totally or partially relinquishing powers.

e. Creditor and marital issues

Relinquishment of a revolving door power should not affect the rights of the grantor's creditors or spouse.

5. Relinquish power to distribute income to grantor's spouse

The grantor may have named his spouse as a beneficiary of the trust, even in a trust that primarily benefits the grantor's descendants, just to be sure that the trust assets will be available for the spouse's support if necessary.

Code section 677(a) provides that the grantor will be treated as the owner of any portion of a trust whose income may be distributed or accumulated for future distribution to the grantor's spouse. To terminate grantor trust status during the marriage, the grantor's spouse must release her right to distributions.

Code section 672(e) provides that a grantor will be 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." Assume Husband funds an irrevocable trust whose income can be distributed to Wife. The income of the trust should be taxed to Husband under Code section 677. If Husband and Wife are later divorced, Code section 682 generally prevents Husband from being taxed on the trust's income that may be distributed to Wife post-divorce. Note, however, that while Code section 682 operates as

an important safety valve for Husband in this scenario, it would not prevent Husband from being taxed on accumulated capital gains post-divorce.[210] Thus, in the event of a divorce, turning off grantor trust status with respect to capital gains may require affirmative action by the beneficiary spouse, which, as a practical matter, may be difficult to obtain.

a. Income tax considerations

See X.B.1.a above.

b. Transfer tax considerations

The spouse's lifetime release of her right to distributions will constitute a gift to the other beneficiaries of the trust in an amount equal to the fair market value of the right.[211] Depending upon the terms of the trust, valuing this gift could be very difficult. Important considerations are:

- Does the trust instrument require distribution of some or all of the income to the spouse or are distributions subject to the trustee's discretion?
- If distributions of income are subject to the trustee's discretion, what is the standard for distribution? Is it only for health, education, maintenance, and support? Or does the trustee have broader discretions to distribute for comfort, happiness, etc.?
- Is the standard mandatory (*e.g.*, the trustee "shall" distribute) or permissive (*e.g.*, the trustee "may" distribute)?
- What factors does the trustee take into consideration in deciding whether to distribute income under the standard? For example, are the spouse's other assets or income relevant?
- If other factors are relevant, is the trustee required to consider them (shall) or only permitted to do so (may)?

The spouse has the burden of demonstrating the value of the beneficial interest she relinquishes. Note that counseling the spouse under these circumstances could be an extremely difficult task. Not only may it be appropriate to advise the spouse to hire an appraiser to determine the fair market value of the spouse's beneficial interest in the trust, depending on such fair market value it may also be appropriate or required for the spouse to file a federal gift tax return reporting such gift. In this instance, it is unlikely that the gift, which would necessarily be a gift in trust, would qualify for the gift or GST tax annual exclusions.

While there may be difficulties in valuing the spouse's beneficial interest in the trust, note that the spouse's ability to release her interest should not be limited by a spendthrift

provision in the trust instrument. This is because releasing a discretionary interest, like exercising a power of appointment, should not be considered a transfer of property for spendthrift purposes.[212] Query, however, whether the result would be any different under the fraudulent transfer rules if the spouse released her beneficial interest in the trust when she had knowledge of an existing creditor's claim?

c. Fiduciary duties

The spouse, as a beneficiary would not owe a fiduciary duty to the other beneficiaries to retain her right to receive income distributions.

d. Administrative issues

The spouse must adhere to the terms of the trust instrument and the provisions of local law governing the procedure for relinquishing a beneficial interest in the trust.

e. Creditor and marital issues

Assuming the trust has a spendthrift clause, the spouse's creditors cannot reach her interest prior to distribution. *Query*: If the spouse is entitled to mandatory distributions of income and the spouse is insolvent, is relinquishment of the income interest a transfer in fraud of creditors?

Assuming the grantor supports the spouse's action, relinquishment of the income interest should create no marital property issues.

6. Use trust principal to pay life insurance premiums

Code section 677(a)(3) provides that the grantor shall be treated as the owner of any portion of a trust whose income "may be" applied to the payment of premiums on insurance on the life of the grantor or the grantor's spouse. Several decisions applying a predecessor statute similar to section 677(a)(3) held that the grantor was taxable only on trust income actually used to pay the premiums, and not on excess trust income.[213] Thus, despite its broad language, section 677(a)(3) may cause grantor trust status only in limited situations. The obvious solution to avoid grantor trust status is to not pay insurance premiums or to pay premiums only with principal, if the trust instrument and applicable state law permit.[214]

a. Income tax considerations

See X.B.1.a above.

b. Transfer tax considerations

Charging life insurance premiums to income or principal should not have transfer tax consequences for the grantor.

c. Fiduciary duties

If the trustee is required to pay life insurance premiums from principal, then doing so should not violate any fiduciary duty. The issue may be more complicated if the trustee has discretion to pay life insurance premiums from income or principal. If the trust has different beneficiaries of income and principal, the trustee must take into account their interests in deciding how to charge premiums. The trustee's payment of premiums from principal solely for the purpose of avoiding grantor trust status, may violate his duty of loyalty to the beneficiaries.

d. Administrative issues

Trust accounting records should clearly reflect whether life insurance premiums were charged to the principal account or the income account.

e. Creditor and marital issues

Ordinarily, deciding whether to charge life insurance premiums to income or principal should not affect creditors or a spouse of the grantor.

7. Plan distributions to beneficiaries in order to minimize combined income tax

ATRA increased income tax rates and, as a result, after grantor trust status is turned off and the burden of taxation on trust income falls on the trust or its beneficiaries, the trustee and the beneficiaries will be more sensitive to minimizing income tax on trust income. A trustee of a non-grantor trust may have the flexibility to distribute trust assets among beneficiaries who are in a lower income tax bracket compared to the trust and other beneficiaries.

a. Income tax considerations

Distributing trust assets to beneficiaries in a way that carries out distributable net income may result in less overall income tax than if the trust income had been taxed to the grantor or to the trust.

b. Transfer tax considerations

Assets distributed to beneficiaries will be in their gross estates for estate tax purposes unless consumed or given away before death.

c. Fiduciary duties

The trustee should adhere to the trust instrument in deciding whether to make distributions to beneficiaries and in what amounts.

d. Administrative issues

Shifting the burden of taxation on trust income obviously affects the responsibility to report that income to the Internal Revenue Service. The parties should ensure that all reporting requirements of Forms 1040 and 1041 are met.

e. Creditor and marital issues

Assets distributed to beneficiaries will be available to satisfy claims of their creditors and spouses.

XI. Conclusion

ATRA transformed estate planning into a new game governed by new rules. For many of our clients, estate tax may no longer be relevant (or, if relevant, then less so), but income tax is more relevant. For those clients, the object of the estate planning game is no longer to reduce estate tax; rather, it is to reduce income tax. Prior to ATRA, the rules of the game were: remove assets from the gross estate (at a discount if possible) and achieve discounts on the assets we could not remove. After ATRA, for some clients at least, the rules are reversed: bring assets into the gross estate and avoid discounts that reduce the value of those assets. The goal of this paper is to suggest ways in which estate planners can help their clients play by the new rules so that they can achieve the new goal ATRA has given them.

EXHIBIT A

EFFECT OF STATE INCOME AND ESTATE TAX REGIMES IN ANALYSIS OF WHETHER TO PAY ESTATE TAX OR INCOME TAX

(This information prepared by, and is used with the consent of, Barbara A. Sloan and T. Randolph Harris)

Assume that the combined assets of a married couple do not exceed a single federal applicable exclusion amount, so that no federal estate tax is involved in analyzing the client's tax situation. The Question posed is whether, based on the paradigm shift in income taxation of capital gain, the client's family is better off leaving appreciated assets in an existing irrevocable trust, thus requiring the remainder beneficiaries to pay income tax on the capital gain upon sale after the termination of the trust, or whether the client's family is better off moving the assets out of the trust to a beneficiary to take advantage of the basis adjustment at the beneficiary's death, but possibly requiring the payment of state estate tax.

To illustrate the analysis, assume that there is an existing bypass trust for the benefit of the surviving spouse holding assets valued at $3 million, the surviving spouse has assets valued at $2 million and there are two children who are the remaindermen of the bypass trust and of the surviving spouse's estate. Also assume the two children sell any assets they receive immediately upon receipt.

SCENARIO 1 - All members of client's family live in Texas which has no estate tax and no income tax.

FACTS: Income tax basis of trust assets is $1 million.

RESULT:

	Estate Tax	**Income Tax on $2 MM**
Bypass Trust Paid Out	$0	$0
Bypass Trust Preserved	$0	$476,000 Federal tax (23.8%)

ANALYSIS: Best for bypass trust to be paid out to the surviving spouse to save $476,000 of tax.

<u>SCENARIO 2</u>—All members of client's family live in New York which has an estate tax similar to that calculated using the state death tax credit table and an effective combined federal and state income tax rate on capital gains of 31.4%.

FACTS: Income tax basis of trust assets is $ 1 million

RESULT:

	Estate Tax	**Income Tax on $2 MM**
Bypass Trust Paid Out	$391,600	$0
Bypass Trust Preserved	$0	$628,000

ANALYSIS: Best result is to pay bypass trust out to surviving spouse to save $236,400 of tax.

<u>SCENARIO 2</u> (continued)

NEW FACTS: Income tax basis of trust assets is $2 million.

	Estate Tax	**Income Tax on $1 MM**
Bypass Trust Paid Out	$391,600	$0
Bypass Trust Preserved	$0	$314,000

ANALYSIS: Best result is to preserve bypass trust to save $77,600 of tax.

<u>SCENARIO 3</u>: All members of client's family live in California which does not have an estate tax and has an effective combined federal and state income tax rate on capital gain of 33%.

FACTS: Income tax basis of trust assets is $1 million.

RESULTS:

	Estate Tax	**Income Tax on $1 MM**
Bypass Trust Paid Out	$0	$0
Bypass Trust Preserved	$0	$660,000

ANALYSIS: Best result is to pay bypass trust out to surviving spouse to save $660,000 of tax (even more savings than Texas scenario).

<u>SCENARIO 4</u>: All members of client's family live in Washington State which has a state estate tax similar to that calculated using the state death tax credit table (exclusion of $2,054,000) but does not have a state income tax.

FACTS: Income tax basis of trust assets is $1 million.

	Estate Tax	**Income Tax on $2 MM**
Bypass Trust Paid Out	$381,900	$0
Bypass Trust Preserved	$0	$476,000 Federal tax (23.8%)

ANALYSIS: Best result is to pay bypass trust out to surviving spouse to save $94,100 of tax.

<u>SCENARIO 4</u> (continued)

NEW FACTS: Income tax basis of trust assets is $2 million.

	Estate Tax	**Income Tax on $1 MM**
Bypass Trust Paid Out	$381,900	$0
Bypass Trust Preserved	$0	$238,000 Federal tax (23.8%)

ANALYSIS: Best result is to preserve bypass trust to save $143,900 of tax.

<u>SCENARIO 5</u>: Surviving spouse lives in New York, which imposes an estate tax, and children live in California, which imposes an income tax.

FACTS: Income tax basis of trust assets is $1 million.

	Estate Tax	**Income Tax on $2 MM**
Bypass Trust Paid Out	$391,600	$0
Bypass Trust Preserved	$0	$660,000

ANALYSIS: Best result is to pay bypass trust to surviving spouse to save $268,400 of tax.

<u>SCENARIO 5</u> (continued)

NEW FACTS: Income tax basis of trust assets is $2 million

	Estate Tax	**Income Tax on $1 MM**
Bypass Trust Paid Out	$391,600	$0
Bypass Trust Preserved	$0	$330,000

ANALYSIS: Best result is to preserve bypass trust to save $61,600 of tax.

<u>SCENARIO 6</u>: Surviving spouse lives in New York, which imposes an estate tax, and children live in Washington State, which does not impose a state income tax.

FACTS: Income tax basis of trust assets is $1 million

	Estate Tax	**Income Tax on $2 MM**
Bypass Trust Paid Out	$391,600	$0
Bypass Trust Preserved	$0	$476,000 Federal tax (23.8%)

ANALYSIS: Best result is to pay bypass trust out to surviving spouse to save $84,400 of tax.

<u>SCENARIO 6</u> (continued)

NEW FACTS: Income tax basis of trust assets is $2 million

	Estate Tax	**Income Tax on $1 MM**
Bypass Trust Paid Out	$391,600	$0
Bypass Trust Preserved	$0	$238,000 Federal tax (23.8%)

ANALYSIS: Best result is to preserve bypass trust to save $153,600 of tax.

<u>SCENARIO 7</u>: Surviving spouse lives in New York, which imposes an estate tax; one child lives in California, which imposes an income tax, and one child lives in Washington State, which does not impose an income tax.

FACTS: Income tax basis of trust assets is $1 million. In the following charts, the amounts of tax shown are reduced by one-half so that the tax results for each child can be compared based on that child's share of the trust and surviving spouse's estate.

	Estate Tax	**Income Tax on $1 MM in CA for one child**	**Income Tax on $1 MM in WA for one child**
Bypass Trust Paid Out	$195,800 (for each child)	$0	$0
Bypass Trust Preserved	$0	$330,000	$238,000 Federal tax (23.8%)

ANALYSIS: Best result for both children is to pay bypass trust out to surviving spouse.

<u>SCENARIO 7</u> (continued)

NEW FACTS: Income tax basis of trust assets is $2 million.

	Estate Tax	**Income Tax on $500,000 in CA for one child**	**Income Tax on $500,000 in WA for one child**
Bypass Trust Paid Out	$195,800 (for each child)	$0	$0
Bypass Trust Preserved	$0	$165,000	$119,000 Federal tax (23.8%)

ANALYSIS: Best result for both children is to preserve the bypass trust.

<u>SCENARIO 7</u> (continued)

NEW FACTS: Income tax basis of trust assets is $1.5 million.

	Estate Tax	Income Tax on $750,000 in CA for one child	Income Tax on $750,000 in WA for one child
Bypass Trust Paid Out	$195,800 (for each child)	$0	$0
Bypass Trust Preserved	$0	$247,500	$178,500 Federal tax (23.8%)

ANALYSIS: Best result for child in California is to pay out the bypass trust to the surviving spouse. Best result for child in Washington State is to preserve the bypass trust.

Endnotes

[1] John F. Bergner Mending Wayward Wealth Strategies, 44th Annual Heckerling Institute on Estate Planning (Jan. 26, 2010).

[2] United States Department of Labor, *Consumer Price Index-All Urban Consumers*, BUREAU OF LABOR STATISTICS, All Items, 1982-84=100 (CPI-U).

[3] From 168.8 in January 2000 to 233.916 in January 2014.

[4] For a helpful chart summarizing tax consequences in various states, *see* Carlyn S. McCaffrey, Some Current Developments in Estate Planning, McDermott, Will & Emery LLP Family Office Symposium, 2 (Apr. 2014 (taking into account the federal income tax, the Medicare tax, the cost of phasing out itemized deductions, and the state and local income tax).

[5] *See* Department of Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals* (Mar. 2014) at 158-159 (the "Green Book").

[6] This paper uses the terms "settlor" and "grantor" interchangeably to refer to the person who creates and funds a trust.

[7] Jeffrey Pennell & Alan Newman, *Estate and Trust Planning* (2d ed. 2005; Lauren Rocklin, *How Estate Planners Can Avoid Malpractice Claims*, 39 ESTATE PLANNING JOURNAL 26 (July 2012).

[8] Treas. Reg. § 20.2031-1(b).

[9] I.R.C. § 1014(a)(1); Treas. Reg. §§ 1.1014-1(a), 1.1014-3(a). In this paper, all references to the "Code" or to "I.R.C." are to the Internal Revenue Code of 1986, and all references to a "section" are to sections of the Code, unless otherwise indicated. Section 2004 of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, P.L. 114-4, enacted on July 31, 2015, created new I.R.C. §§ 1014(f) and 6035 which adopted provisions regarding basis consistency in valuing assets for estate tax inclusion and income tax purposes. Under new I.R.C. § 1014(f) recipients of assets from a decedent must use the values of the assets used for estate tax purposes to determine basis. Under new § 6035 executors must provide information statements to the beneficiaries and the IRS about the value of estate assets. Penalties can be imposed on the executor and the beneficiaries if they fail to follow this newly enacted legislation.

[10] *See* I.R.C. § 731(a)(1). The term "money" includes marketable securities. *See* I.R.C. § 731(c).

[11] *See* I.R.C. § 731(a)(2).

[12] *See* I.R.C. § 707(b).

[13] *See* I.R.C. § 732(b).

[14] *See* I.R.C. § 732(c).

[15] *See* Richard B. Robinson, "Escape From the World of FLPs: Can You Get Out Without Paying a Boatload of Taxes?," 44th Annual Heckerling Institute on Estate Planning (Jan. 26, 2010), for a detailed discussion of the potential tax consequences of unwinding limited partnerships.

[16] *See* I.R.C. § 2701(d).

[17] Treas. Reg. § 301.6501-1(f)(4).

[18] *See* Carol A. Cantrell, Income Tax Problems when the Estate or Trust is a Partner, ALI-ABA Planning Techniques for Large Estates (April 19, 2014), for a more thorough analysis of the income tax consequences of the liquidation of an entity.

[19] *See* I.R.C. § 731(a).

[20] *See* I.R.C. § 732(b).

[21] *See* I.R.C. § 732(c).

[22] *See* I.R.C. § 2701(d).

[23] *See, e.g*., TEX. BUS. ORGS. CODE §§ 101.114 (LLCs), 153.102 (limited partnerships); FLA. STAT. §§ 605.0304 (LLCs), 620.1303 (limited partnerships); New York Limited Liability Company Law § 609 (LLCs), New York Revised Limited Partnership Act § 121-303 (limited partnerships).

[24] *See* I.R.C. § 2701(d).

[25] Treas. Reg. § 301.6501-1(f)(4).

[26] *See, e.g*., ALASKA STAT. § 32.11.340(b); TEX. BUS. ORGS. CODE § 152.308(d); NEV. REV. STAT. § 86.401(2)(a).

[27] *See* Jeffrey Burr, *Charging Order Protected Entities and Their Role in Wealth Preservation*, JOURNAL OF FINANCIAL SERVICE PROFESSIONALS (May 2009), available at http://www.jeffreyburr.com/CM/Custom/Charging%20Order%20Article%2009-09-08.pdf.pdf.

[28] *See* I.R.C. § 2701(d).

[29] *Estate of Baird, et al. v. Comm'r,* 82 T.C.M. (CCH) (2001) (16 tracts of Louisiana timberland valued at a 60% discount); *Estate of Williams v. Comm'r*, 75 T.C.M. (CCH) 1758 (1998) (50% interest in Florida timberland valued at a 44% discount).

[30] Treas. Reg. § 301.6501-1(f)(4).

[31] For a discussion of the swap power (as well other powers that produce grantor trust status), *see* Stephen R. Akers, Planning with Grantor Trusts – Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risks, American Law Institute, (Jan. 14, 2009).

[32] *See* I.R.C. § 675(4).

[33] Rev. Rul. 2004-64, 2004-2 CB 7.

[34] *See* Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

[35] *See* Jonathan G. Blattmachr, Bridget J. Crawford, and Elisabeth O. Madden, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 JOURNAL OF TAXATION (July 2008) at 22*; see also* Steve R. Akers & Philip J. Hayes, Estate Planning Issues With Intra-Family Loans and Notes, State Bar of Texas 36th Annual Estate Planning and Probate Course, 57-58 (June 29, 2012).

[36] I.R.C. § 675(4)(C).

[37] Howard M. Zaritsky, *Toggling Made Easy—Modifying a Trust to Create a Grantor Trust*, 36 ESTATE PLANNING JOURNAL (Mar. 2009), at 47; Chief Couns. Adv. Mem.. 200923048, 204.

[38] Treas. Reg. § 25.2702-3(d)(5).

[39] Treas. Reg. § 1.1051-1(b).

[40] Treas. Reg. §§ 1.1014-5; 1.1051-1(b).

[41] Treas. Reg. § 301.6501-1(f)(4).

[42] *See* generally Nenno & Sullivan, 868 T.M., *Domestic Asset Protection Trusts* (2010),; Richard W. Nenno, Planning and Defending Domestic Asset-Protection Trusts, American Bar Association, Tax Section Meeting (Jan. 24, 2014).

[43] *See, e.g*., CAL. PROBATE CODE § 15304(a); FLA. TRUST CODE § 736.0505(b); IDAHO CODE § 15-7-502(4); TEX. PROP. CODE § 112.035(d).

[44] Lischer, 52 T.M., *Incomplete Lifetime Transfers: Retained Beneficial Interests Under Sections 2036(a)(1) and 2037*.

[45] *Id*. at § II.D.3.b.(3)(b)(ii).

[46] I.R.C. § 2001(b).

[47] I.R.C. § 2012.

[48] *See* Treas. Reg. § 20.2036-1(c)(1)(i) ("An interest or right is treated as having been retained or reserved if *at the time of the transfer* there was an understanding, express or implied, that the interest or right would later be conferred.") (emphasis added); *see also Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, 382 F3d 367 (3d Cir. 2004) ("Section 2036(a)(1) returns an inter vivos transfer to decedent's gross estate if there is an express or implied agreement *at the time of transfer* that the transferor will retain lifetime possession or enjoyment of, or right to income from, the transferred property.") (emphasis added).

[49] I.R.C. § 2001(b).

[50] I.R.C. § 2012.

[51] *See, e.g*., *Shook v. United States*, 713 F.2d 662 (11th Cir. 1983). B*ut see Van Alen v. Comm'r*, 106 T.C.M. (CCH) (2013).

[52] Treas. Reg. § 25.2702-5(c)(6).

[53] Treas. Reg. § 25.2702-5(c)(9).

[54] *See* Treas. Reg. § 25.2702-5(c)(9).

[55] I.R.C. § 267(a).

[56] Prop. Treas. Reg. § 1.7872-11(a)(1).

[57] Treas. Reg. § 301.6501-1(f)(4).

[58] *See, e.g*., FLA. CONST. Art. X, § 4(a); HAW. REV. STAT. § 651-92; TEX. PROP. CODE §§ 41.001-41.024 (all dealing with homesteads).

[59] *See, e.g*., FLA. CONST. Art. X, § 4(c); 750 ILL. COMP. STAT. 65 § 16; TEX. FAM. CODE § 5.001.

[60] *See supra,* Section III.B.6.

[61] Treas. Reg. § 25.2702-5(c)(8).

[62] Treas. Reg. § 25.2702-5(c)(8)(C).

[63] *See, e.g*., FLA. CONST. Art. X, § 4(a); HAW. REV. STAT. § 651-92; TEX. PROP. CODE §§ 41.001-41.024 (all dealing with homesteads).

[64] *See, e.g*., FLA. CONST. Art. X, § 4(c); 750 ILL. COMP. STAT. 65 § 16; TEX. FAM. CODE § 5.001.

[65] *See generally* John F. Bergner Beneficiary Flexible Trust, 46th Annual Heckerling Institute on Estate Planning (Jan. 10, 2012).

[66] *See generally* I.R.C. §§ 651, 652, 661, 662. Note that a distribution of property from a trust in-kind to a beneficiary typically does not trigger income tax, unless an election is made to recognize the gain. *See I.R.C.* § 643(e).

[67] *See Estate of Halpern v. Comm'r*, 70 T.C.M. (CCH) 229 (1995).

[68] It is not always clear whether distribution provisions are considered an ascertainable standard. *See* Rev. Rul. 77-60, 1977-1 CB 282, where the IRS ruled that a power to invade corpus as desired "to continue the donee's accustomed standard of living" was not an ascertainable standard relating to health, education, maintenance and support. However, in Priv. Ltr. Rul. 7914036 the IRS ruled that the trustee's authority to

distribute principal to "permit the survivor of us to maintain the standard of living to which he or she was accustomed" was ascertainable.

[69] I.R.C. § 2041(b)(1); Treas. Reg. § 20.2041-1(c).

[70] *See, e.g.*, FLA. STAT. § 736.0814; TEX. PROP. CODE § 113.029; VA. CODE ANN. § 64.2-776.

[71] I.R.C. § 678.

[72] I.R.C. § 2514(b).

[73] I.R.C. § 2652(a).

[74] I.R.C. § 2612(c).

[75] *See generally* Farhad Aghdami and Jeffrey D. Chadwick, Decanting Comes of Age" American Bar Association, Tax Section, Estate and Gift Taxes Committees (May 6, 2011).

[76] I.R.C. § 678(b).

[77] I.R.C. § 2514(e).

[78] John F. Bergner, Waste Not Want Not – Creative Use Of General Powers Of Appointment To Fund Tax-Advantaged Trusts, 41st Annual Heckerling Institute on Estate Planning (Jan. 2007).

[79] *See* Steven R. Akers, *Heckerling Musings 2014 and Current Developments* 45-46 (2014); Ira Mark Bloom, *Powers of Appointment Under the Restatement (Third) of Property: Wills and Other Donative Transfers* 37-40 (2012); Terence S. Nunan, *Basis Harvesting,* 29 PROBATE & PROPERTY (September/October 2011) at 57. *Compare* Restatement (Second) of Property (Donative Transfers) §§ 13.2, 13.4, 13.5, *with* Restatement (Third) of Property (Donative Transfers) § 22.3.

[80] *See* Steven R. Akers, *Heckerling Musings 2014 and Current Developments* 45-46 (2014).

[81] *See, e.g.,* Les Raatz, *Delaware Tax Trap Opens Door to Higher Basis for Trust Assets,* 41 ESTATE PLANNING JOURNAL (Feb. 2014); Les Raatz, USRAP Surprise Delaware Tax Trap When Appointing to an Existing Trust, ACTEC Summer Meeting, Estate and Gift Tax Committee, (June 21, 2014); William R. Culp, *Use of Trust Decanting to Extend the Term of Irrevocable Trusts*, 37 ESTATE PLANNING JOURNAL (June 2010); Jonathan G. Blattmachr & Diana S.C. Zeydel, *Adventures in Allocating GST Exemption in Different Scenarios*, 35 ESTATE PLANNING JOURNAL (Apr. 2008); Mickey R. Davis, Basis Adjustment Planning, State Bar of Texas 38th Annual Advanced Estate Planning & Probate Course (June 12, 2014).

[82] *See* I.R.C. §§ 2041, 2514(b).

[83] *See* I.R.C. §§ 2041(a)(3), 1014(b)(9).

[84] *See* Zaritsky, Howard, *The Rule Against Perpetuities: A Survey of State (and D.C.) Law*, ACTEC SURVEY (2012), available at:

http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf.

[85] The beneficiary can exercise the non-general power of appointment in favor of the same persons who are named as the remainder beneficiaries of the trust. The exercise of the non-general power of appointment does not have to change the disposition of the trust assets. *See* Treas. Reg. §20.2041-1(d). For a detailed discussion of various states' laws regard the DTT, *see* Les Raatz, *Delaware Tax Trap Opens Door to Higher Basis for Trust Assets,* 41 ESTATE PLANNING JOURNAL (Feb. 2014).

[86] Apparently Arizona allows the DTT to be triggered without granting a presently exercisable general power of appointment. *See* Les Raatz, USRAP Surprise Delaware Tax Trap When Appointing to an Existing Trust, ACTEC Summer Meeting, Estate and Gift Tax Committee (June 21, 2014).

[87] For a more complete discussion of USRAP, *see* USRAP Surprise Delaware Tax Trap When Appointing to an Existing Trust, ACTEC Summer Meeting, Estate and Gift Tax Committee (June 21, 2014).

[88] TEX. PROP. CODE § 112.057.

[89] A more complete discussion of the GST tax issues related to the DTT is provided by William R. Culp, *Use of Trust Decanting to Extend the Term of Irrevocable Trusts*, 37 ESTATE PLANNING JOURNAL (June 2010); and Jonathan G. Blattmachr & Diana S.C. Zeydel, *Adventures in Allocating GST Exemption in Different Scenarios*, 35 ESTATE PLANNING JOURNAL (April 2008).

[90] Treas. Reg. § 301.6501-1(f)(4).

[91] *See, e.g.*, FLA. STAT. § 736.04113; TEX. PROP. CODE § 112.054; VA. CODE ANN. § 64.2-730.

[92] *See* I.R.C. § 2512(b).

[93] Property transferred to the surviving spouse will qualify for the marital deduction only if the transfer is in settlement of a bona fide controversy and not merely gratuitous. *See* Treas. Reg. § 20.2056(c)-2(d)(2).

[94] Susan Bart maintains a helpful online comparison of state decanting statutes, which is available at SIDLEY AUSTIN LLP, http://www.sidley.com/state-decanting-statutes/.

[95] TEX. TRUST CODE § 112.071(5).

[96] *See, e.g.*, AZ. REV. STAT. § 14-10819(5); 760 ILL. COMP. STAT. 5 § 16.4(p); TEX. PROP. CODE § 112.086(a)(5).

[97] *See* Treas. Reg. § 1.1001-2(c), Ex. (5) (explaining the tax consequences associated with the termination of grantor trust status for a trust holding a partnership interest with a negative capital account); *see also Madorin v. Comm'r*, 84 T.C. 667 (1985). I.R.C. § 643(e) does not offer any protection in this context because it does not apply to grantor trusts (Subpart E of Subchapter J).

[98] *See, e.g.*, 760 ILL. COMP. STAT. 5 § 16.4(p); TEX. PROP. CODE § 112.086(a)(5).

[99] *See* I.R.C. § 2613(a)(2).

[100] *See* Rev. Proc. 2011-3.

[101] *See, e.g.*, TEX. PROP. CODE §§ 112.072(e), 112.073(f); VA. CODE ANN. § 64.2-778.1.E.1.

[102] *See* Farhad Aghdami and Jeffrey D. Chadwick, Decanting Comes of Age" American Bar Association, Tax Section, Estate and Gift Taxes Committees (May 6, 2011).

[103] I.R.C. § 2612(a).

[104] I.R.C. § 2642.

[105] *See supra,* Section IV.B.3.

[106] *See* I.R.C. § 2652(a).

[107] *See* I.R.C. § 2613(a).

[108] I.R.C. § 678(b).

[109] I.R.C. § 2514(e).

[110] John F. Bergner, Waste Not Want Not – Creative Use Of General Powers Of Appointment To Fund Tax-Advantaged Trusts, 41st Annual Heckerling Institute on Estate Planning (Jan. 2007).

[111] *See* Steven R. Akers, *Heckerling Musings 2014 and Current Developments* 45-46 (2014); Ira Mark Bloom, *Powers of Appointment Under the Restatement (Third) of Property: Wills and Other Donative Transfers* 37-40 (2012); Terence S. Nunan, *Basis Harvesting,* 29 PROBATE & PROPERTY (September/October 2011), at 57. *Compare* Restatement (Second) of Property (Donative Transfers) §§ 13.2, 13.4, 13.5, *with* Restatement (Third) of Property (Donative Transfers) § 22.3.

[112] *See* Steven R. Akers, *Heckerling Musings 2014 and Current Developments* 45-46 (2014).

[113] Treas. Reg. § 20.2056(b)-7(b)(4)(i).

[114] This technique is discussed by Mickey R. Davis in Basis Adjustment Planning, State Bar of Texas 38th Annual Estate Planning & Probate Course, 13 (June 12, 2014).

[115] Treas. Reg. § 20.2010-2T(a).

[116] Treas. Reg. § 25.2056(b)(7)(b)(3).

[117] For a discussion of how to structure a general power of appointment to make its exercise difficult, *see* John F. Bergner, Waste Not Want Not – Creative Use Of General Powers Of Appointment To Fund Tax-Advantaged Trusts, 41st Annual Heckerling Institute on Estate Planning (Jan. 2007).

[118] I.R.C. § 1014(a).

[119] *See, e.g.*, *Estate of Regester v. Comm'r*, 83 T.C. 1 (1984).

[120] Treas. Reg. § 1.671-2(e)(5) (suggesting that the transfer of assets from one trust to a second trust does not change the identity of the grantor unless the transfer results from the exercise of a general power of appointment); Preamble to Treas. Reg. § 1.684-2, 66 Fed. Reg. at 37898 (In the case of property transferred by the exercise of a non-general power from a domestic trust to a foreign trust, "Treasury and the IRS believe that, under general principles regarding limited powers of appointment, the domestic trust, and not the holder of the limited power of appointment, is the transferor of the property.")

[121] *See* PLRs 200101021 (Jan. 8, 2001) and 200210051 (Mar. 8, 2002).

[122] John F. Bergner, Waste Not Want Not – Creative Use Of General Powers Of Appointment To Fund Tax-Advantaged Trusts, 41st Annual Heckerling Institute on Estate Planning (Jan. 2007).

[123] Treas. Reg. §§ 25.2514-1(b)(2), 25.2514-3(e), ex. 3; *Estate of Regester v. Comm'r*, 83 T.C. 1, 8 (1984); I.R.S. Priv. Ltr. Rul. 8535020 (May 30, 1985); I.R.S. Priv. Ltr. Rul. 9451049 (September 22, 1994).

[124] Treas. Reg. §§ 25.2514-1(b)(2), 25.2514-3(e), ex. 3; *Estate of Regester v. Comm'r*, 83 T.C. 1, 8 (1984); I.R.S. Priv. Ltr. Rul. 8535020 (May 30, 1985); I.R.S. Priv. Ltr. Rul. 9451049 (September 22, 1994).

[125] *See* I.R.C. § 674(a), (b)(5), (b)(6), (c), (d).

[126] *See* I.R.C. § 2613.

[127] *See* I.R.C. § 2612(a).

[128] *See* I.R.C. § 2612(b).

[129] Generally, Trustees have a common law duty to keep beneficiaries informed of certain matters with respect to trust administration. In Texas, for example, a trust instrument may not completely waive the trustee's common law duty to keep certain beneficiaries informed. *See* TEX. PROP. CODE § 111.0035(c). ("The terms of a trust may not limit any common-law duty to keep a beneficiary of an irrevocable trust who is 25 years of age or older informed at any time during which the beneficiary (1) is entitled or permitted to receive distributions from the trust; or (2) would receive a distribution from the trust if the trust were terminated."). *Cf.* FLA. STAT. § 736.0813; HAWAII STAT. § 560:7-303.

[130] I.R.C. § 1(h).

[131] I.R.C. § 2001(b).

[132] See I.R.C. §§ 2001(b)(2), 2001(d) (applying to post-1976 gifts) and I.R.C. § 2012(a), (c) (applying to pre-1977 gifts).

[133] *See, e.g.*, *Shook v. United States*, 713 F.2d 662 (11th Cir. 1983). *But see Van Alen v. Comm'r*, 106 T.C.M. (CCH) 427 (2013).

[134] I.R.C. § 1041(a).

[135] I.R.C. § 1041(b).

[136] I.R.C. § 1014(e).

[137] Michael D, Mulligan, *Income, Estate and Gift Tax Effects of Spousal Joint Trusts*, 22 EST. PLAN (1995), at 195.

[138] I.R.C. § 2523.

[139] *See, e.g.*, *In re Marriage of Moore*, 890 S.W.2d 821, 827 (Tex. App.–Amarillo 1994, no writ); *In re Matter of Marriage of DeVine*, 869 S.W.2d 415, 428 (Tex. App.–Amarillo 1993, writ denied); *see also Associated Indem. Corp. v. Cat Contracting*, 964 S.W.2d 276, 287 (Tex. 1998) (finding informal fiduciary duty may arise from moral, social, domestic or purely personal relationship of trust and confidence).

[140] *See, e.g.*, CAL. FAMILY CODE §§ 1500-03; TEX. FAM. CODE §§ 4.101-4.106.

[141] *See, e.g.*, TEX. FAM. CODE § 4.106(a).

[142] I.R.C. § 2523.

[143] *See, e.g.*, *In re Marriage of Moore*, 890 S.W.2d 821, 827 (Tex. App.–Amarillo 1994, no writ); *In re Matter of Marriage of DeVine*, 869 S.W.2d 415, 428 (Tex. App.–Amarillo 1993, writ denied); *see also Associated Indem. Corp. v. Cat Contracting*, 964 S.W.2d 276, 287 (Tex. 1998) (finding informal fiduciary duty may arise from moral, social, domestic or purely personal relationship of trust and confidence).

[144] *See, e.g.*, CAL. FAMILY CODE §§ 1500-03; TEX. FAM. CODE §§ 4.101-4.106.

[145] *See, e.g.*, TEX. FAM. CODE § 4.106(a).

[146] *See, e.g.*, CAL. FAMILY CODE § 850; TEX. FAM. CODE §§ 4.201-4.206.

[147] I.R.C. § 1014(b)(6).

[148] *See* Treas. Reg. § 1.1001(a).

[149] *See* I.R.C. §1041(b) (treating all transfers of property between spouses as gifts for income tax purposes).

[150] I.R.C. § 2523.

[151] *See, e.g.*, *In re Marriage of Moore*, 890 S.W.2d 821, 827 (Tex. App.–Amarillo 1994, no writ); *In re Matter of Marriage of DeVine*, 869 S.W.2d 415, 428 (Tex. App.–Amarillo 1993, writ denied); *see also Associated Indem. Corp. v. Cat Contracting*, 964 S.W.2d 276, 287 (Tex. 1998) (an informal fiduciary duty may arise from a moral, social, domestic or purely personal relationship of trust and confidence).

[152] *See, e.g.*, CAL. FAMILY CODE §§ 850-853; TEX. FAM. CODE §§ 4.201-4.206.

[153] *See, e.g.*, CAL. FAMILY CODE § 910; TEX. FAM. CODE § 3.202.

[154] *See, e.g.*, CAL. FAMILY CODE §§ 2600-2604; TEX. FAM. CODE § 7.001.

[155] *See, e.g.*, CAL. FAMILY CODE § 851; TEX. FAM. CODE § 4.206.

[156] For an in depth discussion of Community Property Trusts, *see* Nancy G. Henderson, M. Read Moore, & Diana S.C. Zeydel, Balancing the Income and Transfer Tax Aspects of Traditional (and Not so Traditional) Estate Planning Techniques: Selected Topics, ACTEC 2014 Summer Meeting, 5-18 (June 2014); and M. Read Moore & Nicole M. Pears, Coming Soon to Your State: Community Property, ACTEC 2013 Fall Meeting (Oct. 2013). For an overview of clients migrating between community and common law states, *see* Kenneth W. Kingma, Esq., Estate Planning for Married Couples Migrating Between Common Law States and Community Property States, ACTEC 2013 Fall Meeting (Oct. 24, 2013). For a comparative summary of community property laws, *see* Steve R. Akers, *ACTEC 2013 Fall Meeting Musings* (2013).

[157] The nine community property states are Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington, and Wisconsin, which allows spouses to elect out.

[158] *See, e.g.*, CAL. FAMILY CODE § 910; TEX. FAM. CODE § 3.202.

[159] *See, e.g.*, CAL. FAMILY CODE §§ 2600-2604; TEX. FAM. CODE § 7.001.

[160] *See, e.g.*, CAL. FAMILY CODE § 851; TEX. FAM. CODE § 4.206.

[161] *See* John F. Bergner, Waste Not Want Not – Creative Use of General Powers of Appointment to Fund Tax-Advantaged Trusts, 41st Annual Heckerling Institute on Estate Planning (Jan. 2007).

[162] I.R.C. § 2523.

[163] An individual's MAGI for purposes of calculating the NIIT is the individual's adjusted gross income, increased for foreign earned income (net of deductions and exclusions disallowed for the foreign earned income) excluded from the individual's adjusted gross income.

[164] For a more complete discussion of the NIIT, s*ee, e.g.,* Richard L. Dees,, *20 Questions (and 20 Answers!) on the New 3.8% Percent Tax*, *Part I*, TAX NOTES (August 12, 2013); and Richard L. Dees, *20 Questions (and 20 Answers!) on the New 3.8% Percent Tax*, *Part 2*, TAX NOTES (August 19, 2013); Edwin P. Morrow, III,, *Avoid the 3.8 Percent Medicare Surtax*, TRUSTS AND ESTATES (December 2012), at 32; Jonathan G. Blattmachr, Mitchell M. Gans & Diana S.C. Zeydel, *Imposition of the 3.8% Medicare Tax on Estate and Trusts*, 40 ESTATE PLANNING (April 2013), at 3; Akers, Steve R., *Heckerling Musings 2014 and Current Developments*, 63 (2014).

[165] Treas. Reg. § 1.1411-3(b)(1).

[166] Treas. Reg. § 1.1411-3(b)(1).

[167] Treas. Reg. § 1.1411-4(a-h).

[168] I. R.C. § 1411(c).

[169] Treas. Reg. § 1.1411-5(a-b). The activity must involve a trade or business within the meaning of Code section 162 and be a non-passive activity within the meaning of Code section 469.

[170] Treas. Reg. § 1.469(c)(7)(B).

[171] I.R.C. § 469(c)(7).

[172] *See* I.R.S. Priv. Ltr. Rul. 201029014 (July 23, 2010).

[173] *See* TAM 201317010 (April 26, 2013). The trust owned an S-corporation. The trustee was not active with respect to the business. The individual serving as "special trustee" had very limited powers, but was president of the business. The Service ruled that the trustee and special trustee weren't involved in operations of the S-corporation's relevant activities on a regular, continuous, and substantial basis. The activities of the special trustee as an employee of the business could not count toward meeting the material participation requirements.

[174] *Mattie K. Carter Trust v. Comm'r,* 256 F. Supp. 2d 536 (N.D. Texas 2003).

[175] *Frank Aragona Trust v. Comm'r*, 142 T.C. No. 9 (March 27, 2014).

[176] A more complete discussion of the *Aragona* case is provided by Paul C. Lau, Brian Whitlock and Kurt Piwko, *Tackling Taxes, A Fresh Look at Net Investment Income Tax for Trusts*, TAXES THE TAX MAGAZINE (2014); and by Dana M. Foley and William I Sanderson, *Frank Aragona Trust v. Commissioner, A Road Map to What Really Matters for Material Participation,* PROBATE & PROPERTY (September/October 2014).

[177] *See* TAM 200733023 (August 17, 2007); TAM 201317010 (April 26, 2013).

[178] Treas. Reg. § 1.1411-3(b)(1).

[179] Capital gains are not typically distributed and, therefore, are generally subject to the NIIT. Situations when capital gains are distributable are as follows: (i) distributions in full or partial liquidation of the trust, (ii) the Trustee has the power to adjust and consistently designates principal distributions as capital gains, (iii) capital gains are included in a unitrust distribution or (iv) the trust instrument says that capital gains are

included in trust income. If gains can be allocated to accounting income, distributions to income beneficiaries may be able to reduce or eliminate the NIIT.

[180] I.R.C. § 663(b).

[181] *See* I.R.C. §663(b).

[182] *See* I.R.C. § 101(g)(2).

[183] *See* I.R.C. §§ 61(a)(10); 72(e); *see also* Rev. Rul. 2009-13.

[184] *See* I.R.C. § 72(e). For a more detailed discussion, *see* Donald O. Jansen & Lawrence Brody, So, You Think You Know Everything About Income Taxation of Life Insurance, 47th Annual Heckerling Institute on Estate Planning (Jan. 2013).

[185] *See, e.g.,* FLA. STAT. 222.14; TEX. INS. CODE § 1108.001 *et seq*.

[186] For a more detailed discussion of valuing life insurance policies, *see* Lawrence Brody & Mary Ann Mancini, Sophisticated Life Insurance Techniques, ACTEC 2010 Annual Meeting, 67 – 75 (March 14, 2010); *see also* Mary Ann Mancini, Is Life Insurance Still Relevant in 2013?, 35th Annual Duke Estate Planning Conference (Oct. 18, 2013), available at http://www.loeb.com/~/media/Files/Events/2013/10/Is%20Life%20Insurance%20Still%20Relevant%20in%202013.pdf.

[187] I.R.C. § 1001(a)(1). B*ut see* I.R.C. § 101(g)(2) (addressing viatical settlement when insured is terminally ill).

[188] *See* Rev. Rul. 2009-13, Situation 2,*citing London Shoe Co. v. Comm'r*, 80 F.2d 230, 231, (2d Cir. 1935); *Century Wood Preserving Co. v. Comm'r*, 69 F.2d 967, 968, (3d Cir. 1934).

[189] Rev. Rul. 2009-13 (Situation 3).

[190] Rev. Rul. 2009-13 (Situation 2).

[191] *See* I.R.C. § 2512(b).

[192] *See, e.g.,* FLA. STAT. 222.14; TEX. INS. CODE § 1108.001 *et seq*.

[193] *See* Rev. Rul. 85-13.

[194] *See* Rev. Rul. 85-13.

[195] I.R.C. § 101(a)(2).

[196] *See* I.R.C. § 101(a)(2).

[197] I.R.C. § 101(a)(2)(B).

[198] I.R.C. § 101(a)(2)(A).

[199] *See, e.g.,* FLA. STAT. § 222.14; TEX. INS. CODE § 1108.001 *et seq*.

[200] A grantor trust is a trust whose assets, for income tax purposes, are deemed to be owned by the grantor and whose items of income, deduction, and credit are attributable to the grantor rather than to the trust as a separate taxpayer. *See* subpart E, part I, subchapter J, chapter 1, subtitle A of the Code (sections 671-678).

[201] Rev. Rul. 2004-64.

[202] *See Madorin v. Comm'r*, 84 T.C. 667 (1985); Rev. Rul. 77-402 (finding death of grantor during term of the note results in income realization because grantor trust status is lost and relief of indebtedness occurs).

[203] I.R.C. § 674(c).

[204] I.R.C. § 674(b)(5).

[205] *See* I.R.C. §§ 674(b)(4) (power to allocate among charitable beneficiaries), 674 (b)(6) (power to distribute or withhold if ultimately payable to the beneficiary or certain other alternate takers), and 674 (b)(7) (power to withhold while beneficiary is disabled).

[206] I.R.C. § 674(d).

[207] *See* Treas. Reg. § 25.2511-2.

[208] I.R.C. § 2035(a).

[209] *See* Rev. Rul. 95-58.

[210] *See* I.R.S. Priv. Ltr. Rul. 200408015. For a more detailed discussion regarding the impact of Code section 682 on grantor trust status in the event of a divorce, see Barry Nelson & Richard Franklin, *Inter Vivos QTIP Trusts Could Have Unanticipated Income Tax Results to Donor Post-Divorce,* LISI ESTATE PLANNING NEWSLETTER #2244 (September 15, 2014), available at http://www.leimbergservices.com.

[211] *See* Restatement (Third) of Trusts cmt. g ("A release is treated for many purposes, but not all (*see, e.g.*, § 58, cmt c.), as a transfer of the renounced interest to those who benefit from the release, generally to be determined as if the beneficiary had died at the time of the release.").

[212] *See* Uniform Trust Code § 502 cmt. b ("Releases and exercises of powers of appointment are also not affected [by a spendthrift clause] because they are not transfers of property."), *citing* Restatement (Third) of Trusts § 58 cmt. c.

[213] *See* Robert T. Danforth and Howard M. Zaritsky, 819 T.M., *Grantor Trusts: Income Taxation Under Subpart E*, ¶ IX.B, and n.465.

[214] *See, e.g.*, TEX. PROP. CODE § 116.202(a)(5) (premiums on insurance policies, other than insurance covering loss of principal asset or loss of income from or use of asset, are chargeable to principal).

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