Big Issues for Estate Planning Practices in the Current Environment

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INTRODUCTION

This summary of big issues for estate planning practices in the current environment includes a discussion of various current developments.

1. LEGISLATIVE DEVELOPMENTS—WHAT IS THE "CURRENT ENVIRONMENT" (AS IT MAY BE IMPACTED BY LEGISLATIVE PROPOSALS)?

a. **Transfer Tax Legislation Unlikely in the Near Term**. The various transfer tax proposals in the Administration's Fiscal Year 2015 Revenue Proposals (released by the Treasury on March 2, 2014) will likely proceed only as part of a general tax reform package, and not as a package of separate transfer tax legislation. There have been some indications, however, that transfer taxes are not being considered in the reform measures. With Republicans controlling both the House and Senate, legislation to enhance transfer tax measures seems highly unlikely.

b. **Fundamental Tax Reform Unlikely**. The approaches for fundamental tax reform by the Congress and President have substantial differences. The prospect of fundamental tax reform is unlikely without Congress's ability to override a Presidential veto.

c. **Transfer Tax Repeal Possibilities**. Some talk has arisen again of the possibility of the repeal of transfer taxes. In the last several years, Republicans who supported estate tax repeal were reluctant to raise the issue, for fear that the substantial decreases in transfer taxes achieved in ATRA might be lost. With Republicans controlling both houses of Congress, that is not a realistic fear at this point. There is a greater chance of estate tax repeal this year than last year, but still just "better than nominal."

   Some planners have wondered whether with the President's tax proposal to trigger capital gains taxation upon death (or when making gifts) without a basis increase under §1014, while also keeping the estate tax, might be an overture to negotiate for allowing a repeal of the estate tax if Congress would agree to the capital gains on gift or death proposal. Representative Kevin Brady (Republican-Texas), a member of the House Ways and Means Committee, has already stated that the President's "reneging on the 'permanence' of the estate tax agreements" is creating a movement to have a floor vote this year on repealing the estate tax. Daily Tax Report, at 22DTR GG-3 (Feb. 3, 2015).

d. **President's 2016 Fiscal Year Budget Proposal: Increasing Taxes on Wealth, Reducing Taxes on Middle Class, Business Tax Reform**. The Treasury on February 2, 2015 released the General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (often referred to as the "Greenbook") to provide the details of the administration's budget proposals. For a discussion of the proposals impacting estate planning in the 2014 Fiscal Year Revenue Proposals, see Item 1.c of the Hot Topics and Current Developments Summary (2013) found here and available at www.Bessemer.com/Advisor. A few summary comments about specific proposals, and in particular with comments about new provisions in the 2016 Fiscal Year Greenbook and the 2015 Fiscal Year Greenbook are included below. (The revenue estimates are from the Fiscal Year 2016 Greenbook.)

   Treating Gifts and Bequests as Realization Events. A major new proposal in the Fiscal Year 2016 Plan would raise substantial income taxes by closing the "trust loophole,"

to cause an immediate realization of gain upon making gifts or at death (with an elimination of the basis step-up at death under §1014). The description released in connection with the State of the Union Address refers to the basis step-up under §1014 as "perhaps the largest single loophole in the entire individual income tax code." Some of the specific elements of the proposal include:

- Treating bequests and gifts other than to charitable organizations as realization events;
- For couples, no tax would be due until the death of the surviving spouse;
- Allowing an exemption from capital gains at death of up to $100,000 per individual ($200,000 per couple), which exemptions would be portable between spouses;
- Allowing an exemption for personal residences for capital gains up to $250,000 per individual ($500,000 per couple), which exemptions would also be portable between spouses;
- Exempting tangible personal property (other than expensive art) and similar collectibles;
- Allowing relief from the immediate realization of income for inherited small family-owned and operated businesses unless and until the business was sold; and
- Allowing a closely-held business the option to pay the tax on gains over 15 years.

The President's proposal calls for realization of income taxes on appreciation at death and also retains the estate tax. An example in the Greenbook describes a decedent with stock worth $50 million that has a basis of $10 million. It states that because the heir's basis in the stock is "stepped up" to $50 million, no income tax is ever due on the $40 million of gain. The example does not point out that the $50 million of stock will be subject to a $20 million estate tax (assuming the decedent had previously used her unified credit). The Greenbook makes clear that this proposal applies in addition to the estate tax, and the income tax on gains realized at death would be deductible for estate tax purposes. For example, if the income tax is recognized as a deduction against the estate tax (to yield the same result as a deathbed sale), the estate deduction would be $40 million x 28%, or $11.2 million, saving $11.2 million x 40%, or $4.48 million of estate tax. Thus, net tax attributable to the $40 million of appreciation would be $28 million - $4.48 million, or $23.52 million.

This proposal will get no traction in the Republican-controlled Congress—but the sweeping nature of this new approach is quite interesting.

Increased Capital Gains Rates. In addition, the proposal would increase the top rate on capital gains and qualified dividends to 28% for couples with income over about $500,000 (the 2016 Fiscal Year Budget proposal makes clear that the 28% rate includes the 3.8% tax on net investment income).

Effect of Capital Gains Tax Reforms. The President's proposal states that 99% of the financial impact of raising the capital gains rate and eliminating the basis step-up would be on the top 1% of taxpayers, and 80% of the impact would be on the top

0.1% of taxpayers (those with over $2 million of income). The reforms would raise "$208 billion over the first 10 years, with larger revenue gains when fully implemented.") (Estimated ten-year revenue from the capital gains tax reforms including the realization of gains from gifts and bequests and the increased rates: $207.884 billion. Interestingly, this is *much* smaller than the revenue from the proposal to "reduce the value of certain tax expenditures," (including limiting the benefit of most deductions to 28% and limiting other tax benefits such as tax-exempt interest, which is $603.226 billion.)

Section 529 Plans. The proposal at the State of the Union Address also would eliminate the advantages of 529 plans for new contributions and would repeal the tax incentives going forward for the much smaller Coverdell education savings program (but the President no longer supports these proposals in the face of strong opposition).

Other Individual Income Tax Proposals. The proposal also continues the items in the 2015 Fiscal Year Budget Proposal to (1) limit the benefit of most individual deductions to a maximum of 28% with similar limitations of the tax benefits of tax-exempt bonds and retirement plan contributions), and (2) enact a "Buffet Rule" requiring that the income tax be at least 30% of an individual's income for wealthy individuals.

Business Tax Reform. The Fiscal Year 2016 Budget proposal would, among other things:

- lower the corporate tax rate to 28% with a 25% effective rate for domestic manufacturing, to be paid for by additional structural reforms, including accelerated depreciation and reducing the tax preference for debt-financed investment;
- provide relief for small businesses by letting businesses with gross receipts of less than $25 million (more than 99% of all businesses) pay tax based on a cash accounting method and by permanently extending and enhancing the §179 expense deductions to allow deductions for up to $1 million of investments in equipment up front to avoid having to deal with depreciation rules; and
- reform the international tax system, with the core proposal being (i) to apply a 19% minimum tax on foreign earnings that would require U.S. companies to pay tax on all of their foreign earnings when earned "with no loopholes," after which the earnings could be reinvested in the U.S. without additional tax and (ii) to impose a mandatory repatriation tax of 14% on previously earned offshore income.
- Although business tax reform has bipartisan support, the reform is expected to be revenue-neutral, so there will be winners and losers, which will lead to intense political pressure.

Restore 2009 Estate, Gift and GST Tax Parameters, Beginning in 2016. The 2014 and 2015 Fiscal Year Plans proposed restoring the 45% rate/$3.5 million estate and GST exemption/$1 million gift exemption effective beginning in 2018. The 2016 Fiscal Year Plan moves up the effective date to 2016 (while President Obama is still in office). This proposal is not taken seriously (but who knows what could happen in the

process of negotiating tax reform measures). Its continued inclusion (and acceleration) in the 2016 Fiscal Year Plan shows that its inclusion is quite intentional by the Obama Administration. (Estimated 10-year revenue: $189.311 billion, up from $118.282 billion in the 2015 Fiscal Year Plan.)

Require Consistency of Basis for Transfer and Income Tax Purposes. This proposal was enacted July 31, 2015, as discussed below. (Estimated ten-year revenue: $3.237 billion, but the Joint Committee estimate associated with the actual legislation reports estimated ten-year revenue of $1.542 billion.)

New GRAT Requirements Prior to 2016 Fiscal Year Plan. Requirements include (i) a 10-year minimum term, (ii) a maximum term of life expectancy plus 10 years, (iii) a remainder value greater than zero, and (iv) no decrease in the annuity amount in any year. Several years ago, this was included in various bills that needed revenue offset, but it has not been included in any bills over the last several years. The proposal applies to GRATs created after date of enactment; it is extremely unlikely that this will be retroactive to the beginning of the year (as was done—probably inadvertently as to this provision—in the "Trade Adjustment Assistance Extension Act of 2011" legislative proposal).

New GRAT requirements in 2016 Fiscal Year Plan. **The 2016 Fiscal Year Plan adds a requirement that the remainder interest in the GRAT at the time the interest is created has a minimum value equal to the *greater* of 25% of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed). In addition, GRATs would be prohibited "from engaging in a tax-free exchange of any asset held in the trust."** (Apparently the reference to "a tax-free exchange" would include any purchase of assets by the grantor from the GRAT if there was no capital gains tax on that purchase because the prior paragraph of the Greenbook spoke of that as a way of avoiding future capital gains taxes because of the basis step-up that would occur at death if the grantor had purchased the asset.) (**Observation: This would kill GRATs as a practical matter**.) The GRAT proposal and the grantor trust proposal were separate items in last year's proposal but are combined in this year's Plan. Perhaps that was done thinking that the grantor trust proposal had a greater likelihood of passing if it were combined with what had been the less controversial GRAT proposal (but the GRAT proposal in this year's plan will be controversial as well). (Estimated ten-year revenue: Last year's plan broke out the estimated revenue impact of the GRAT provision and grantor trust provision separately, but in the 2016 Plan they are combined. The 10-year revenue impact of the GRAT and grantor trust proposal is $18.354 billion. Last year, the revenue impact of the GRAT proposal was $5.711 billion and $1.644 billion for the grantor trust proposal, totaling $7.355 billion. This is a substantial increase in the 2016 Fiscal Year Plan.)

Limit Duration of GST Exemption to 90 years. This proposal has not generated a groundswell of criticism. The proposal would apply to trusts created after the date of enactment and to the portion of preexisting trusts attributable to additions after that date (subject to rules substantially similar to the grandfather rules). (Estimated ten-year revenue impact: Negligible.)

Sales to Grantor Trusts. The 2014 Fiscal Year Plan substantially narrowed this proposal from the 2013 Fiscal Year Plan (which would have included all grantor trusts in the settlor's gross estate). The 2014 Fiscal Year Plan provides generally that if there

are sales to grantor trusts, the portion in the trust attributable to the sale (net of the amount of consideration received by the grantor in the transaction) would be in the grantor's gross estate (or would be a gift from the grantor if grantor trust status of the trust terminated during his lifetime). The 2015 Fiscal Year Plan clarified that the proposal generally would not apply to irrevocable life insurance trusts. There was no further change in the 2016 Fiscal Year Plan proposal. This is a huge change and passage seems unlikely. The proposal applies to trusts that engage in a "sale, exchange or similar transaction" on or after the date of enactment. (Estimated ten-year revenue: $1.644 billion in the 2015 Fiscal Year Plan. See above regarding the GRAT proposal for the revenue estimate in the 2016 Fiscal Year Plan.)

Section 6166 Estate Tax Len. The special estate tax lien under §6324(a)(1) would last for the full period that estate tax is deferred under §6166 rather than being limited to just 10 years after the date of death. (Estimated ten-year revenue: $248 million.) This almost certainly will be included in any transfer tax legislation that passes.

Health and Education Exclusion Trusts. "HEET" trusts are a seldom-used strategy to create a long term trust out of which tuition and medical payments could be made for future generations without any GST tax. Unfortunately, the proposal is Draconian in approach. It would eliminate the current exclusion under §2503(e) for payments from a trust for the health or tuition payments for second generation (and more remote) beneficiaries. Furthermore, the proposal has a seldom used very harsh effective date provision—applying to trusts created after and transfers after the date of the introduction of this bill. (Estimated ten-year revenue: *Negative* $231 million)

Simplify Gift Tax Annual Exclusion. Referencing the complexity of administering *Crummey* trusts and the potential abuses, the 2015 Fiscal Year Plan first proposed deleting the present interest requirement for annual exclusion gifts, allowing the $14,000 per donee exclusion for most outright transfers, and adding a new category of gifts to which a $50,000 *per donor* annual limit would apply. The proposal applies to gifts made after the year of enactment. For a description of the details of this rather confusing proposal, see Item 1.c of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

The 2016 Fiscal Year Plan clarifies this proposal to indicate that "**[t]his new $50,000 per-donor limit would not provide an exclusion in addition to the annual per-donee exclusion**; rather, it would be a further limit on those amounts that otherwise would qualify for the annual per-donee exclusion." In addition, the 2016 Fiscal Year Plan added that the $50,000 amount would be indexed. There seems to be little chance of this proposal passing Congress. (Estimated ten-year revenue: $3.446 billion)

Expand Applicability of Definition of Executor. The definition of "executor" in the Internal Revenue Code that applies only for purposes of the estate tax would be extended to all tax purposes. The proposal would be effective upon enactment, regardless of a decedent's date of death. (Estimate ten-year revenue: Negligible)

Omission of Section 2704 Proposal. In prior years the Obama administration has proposed revising §2704 to add an additional category of applicable restrictions (to be provided in regulations) that would be disregarded in valuing transferred assets. That proposal was dropped in the 2013 and 2014 Fiscal Year plans. There are indications that new proposed regulations under §2704 may be forthcoming in the near future, as discussed below.

Reporting Requirement for Sale of Life Insurance Policies and Change Certain Transfer-for-Value Exceptions. The proposal would change the transfer-for-value rule so that the rule would not apply for transfers to the insured, or to a partnership or a corporation of which the insured is a20-percent owner. (The current exceptions to the transfer-for-value rule also apply for transfer to a partner of the insured or a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer.) Query whether the legislation would be limited to purchases of policies by third-party investors as opposed to transfers of policies among the policy owner and related persons, trusts or entities?

Payment to Non-Spouse Beneficiaries of Inherited IRAs and Retirement Plans over Five Years. The 2014 Fiscal Year Plan added a new proposal requiring that non-spouse beneficiaries of inherited retirement plans and IRAs generally must take distributions over no more than five years. Exceptions are provided for disabled beneficiaries, chronically ill beneficiaries, individuals not more than 10 years younger than the participant, and minor beneficiaries. The 2014 Fiscal Year plan did *not* specifically make this requirement applicable to Roth IRAs. But the 2015 Fiscal Year plan provided that all of the same minimum distribution rules would apply to Roth IRAs as other IRAs (applicable for taxpayers reaching age 70 ½ after 2014). Therefore, Roth IRAs would be subject to the 5-year distribution requirement. Under the 2016 Fiscal Year Plan, the proposal would be effective for plan participants or IRA owners dying after 2015, and the proposal appears to apply to Roth IRAs only if the owner reached age 70 ½ after 2015 and to owners who die after 2015 after reaching age 70½. The general five-year proposal, while a dramatic change, has significant acceptance on a policy basis of requiring that retirement plans be used for retirement. However, extending this rule to existing Roth IRAs seems very unfair. (Estimated 10-year revenue of the general 5-year proposal: $5.479 billion)

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

Limit Total Accrual of Tax Favored Retirement Benefits. This proposal, also added in the 2014 Fiscal Year Plan, generally would limit the deduction for contributions to retirement plans or IRAs with total balances under all such plans that are sufficient to provide an annual benefit of a particular amount ($210,000 in 2014), representing plan amounts of about $3.2 million for a 62-year old individual in 2014. The 2016 Fiscal Year Plan updates the plan amount to about $3.4 million (which amount will decrease if interest rates increase), enough to provide an annual income of $210,000. Commentators have observed that this provision can be complex to administer because individuals would have to disclose the value of all of their retirement plans to employers, who would then have to monitor the value of all such plans. (Estimated 10-year revenue: $26.043 billion)

Eliminate MRD Requirements for Qualified Plans and IRAs under Aggregate Amount of $100,000 (Indexed). The minimum required distribution rules would not apply if the

aggregate value of the individual's IRA and qualified plan accumulations does not exceed $100,000 (indexed for inflation). The proposal applies to individuals reaching age 70½ after 2014 or who die after 2014 before attaining age 70½.

60-Day Rollover for Inherited Retirement Benefits. Under current law, surviving spouses may receive benefits from an IRA outright and roll them over to another IRA (a "60-day rollover"), but beneficiaries other than spouses may only make a trustee-to-trustee transfer from the decedent's IRA to an inherited IRA. The 2015 Fiscal Year plan for the first time acknowledges that the trustee-to-trustee transfer requirement "creates traps for the unwary" for non-spouse beneficiaries, and allows non-spouse beneficiaries to make 60-day rollovers to another IRA. The proposal applies under the 2016 Fiscal Year Plan to distributions after 2015. (Estimated 10-year revenue: Zero)

Enhance Administrability of Appraiser Penalty. Section 6694 imposes a preparer penalty for unreasonable positions and for willful or reckless conduct. Section 6695A imposes an appraiser penalty if the claimed value of property based on an appraisal results in a substantial or gross valuation misstatement. The proposal replaces a "more likely than not" exception with a "reasonable cause" exception. In addition, the appraiser penalty would not apply if the appraiser is also subject to the preparer penalty. The proposal in the 2016 Fiscal Year Plan would apply to returns filed after 2015. (Estimated 10-year revenue: Zero).

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

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

- for charitable contributions of property by S corporations, the shareholder's basis is reduced only by the contributed property's basis; and
- 100% exclusion from gross income of gain from the sale of qualified small business stock.

At some point in 2015 (possibly in December if past history is a guide), Congress will be considering an extension of various extenders for 2015.

f. **ABLE Accounts**. The Achieving a Better Life Experience Act of 2014 (the "ABLE Act") created new Code section 529A. It allows the creation of accounts somewhat like 529 Plans for individuals with disabilities. States are authorized to create qualified ABLE programs for individuals who qualified for SSI or SSD -- or who met similar tests of disability -- before age 26. Only a single account could be created for any individual, and contributions to the account are limited in the aggregate to $14,000/year (or the then-current gift tax exclusion figure). The account can grow tax free (like a 529 Plan). If distributions are used to pay "qualified disability expenses," they are not included in gross income. ABLE defines qualified disability expenses liberally, covering many expenses that Medicaid does not already cover. If a distribution is made that is not a qualified distribution, it is subject to a 10% penalty in addition to being included in gross income; such a distribution will also cause the ABLE Account to lose its favorable treatment for eligibility purposes.

Amounts in an ABLE account (up to $100,000) do not count as a resource for SSI qualification purposes. In the event that the account grows above $100,000, SSI eligibility will be suspended but state Medicaid eligibility will continue so long as the account stays below the state's maximum 529 Plan level. The accounts will be handled by the beneficiary directly, and will not remain under the control of the original donor(s). Account balances can in some cases be transferred to other family members who meet the disability criteria. ABLE accounts will be a nice benefit for clients with disabled beneficiaries, and may be useful in connection with special needs trust planning -- but note that all sums in the ABLE account can be claimed by the state Medicaid agency upon the death of the beneficiary, even third-party contributions from family members. The possibilities, limitations and risks will become clearer as the IRS and Social Security Administration adopt regulations implementing the new section 529A, and individual states create (or choose not to create) ABLE accounts.

(Thanks for Robert B. Fleming [Tucson, Arizona] for information included in this summary of ABLE accounts.)

g. **Basis Consistency Provisions in Legislation Extending Highway Trust Fund**.

(1) *Background.* For purposes of determining the basis of assets received from a decedent, the value of the property as determined for federal estate tax purposes generally is deemed to be its fair market value. Treas. Reg. §1.1014-3(a). The estate tax value is not conclusive, however, but is merely a presumptive value that may be rebutted by clear and convincing evidence except where the taxpayer is estopped by the taxpayer's previous actions or statements (such as by filing estate tax returns as the fiduciary for the estate). Rev. Rul. 54-97, 1954-1 C.B. 113; *see* Augustus v. Commissioner, 40 B.T.A. 1201 (1939). In Technical Advice Memorandum 199933001, the IRS ruled that an individual beneficiary who was

not the executor of the estate and took no other inconsistent actions or statements was not estopped from trying to establish that the date of death value (and the basis) was higher than the value reported on the estate tax return. In Janis v. Commissioner, T.C. Memo 2004-117, *aff'd*, 461 F.3d 1080 (9th Cir. 2006) the court applied a duty of consistency where the sole beneficiaries were also the sole co-executors of the estate, The court held that the discounted estate tax value of an art gallery set the basis of individual art works (proportionately), observing that the beneficiaries were not contending that the discounted value was incorrect for estate tax purposes. A duty of consistency was also applied in Van Alen v. Commissioner, T.C. Memo 2013-235, to estop beneficiaries who had signed an agreement consenting to the special use valuation election; the beneficiaries were estopped from arguing that the basis was higher than the special use value.

The President's Budget proposal for fiscal year 2010, published on May 11, 2009 proposed various "loophole closers" to help fund a reserve for health care reform, including a consistency of basis provision. It proposed that gift transferees would be required to use the donor's basis, (except that the basis in the hands of the recipient can be no greater than the value of the property for gift tax purposes). The basis of property received by death of an individual would be the value for estate tax purposes. Regulations would address implementation details, such as rules for situations in which no estate or gift tax return is required, when recipients may have better information than the executor, and when adjustments are made to the reported value after the filing of an estate or gift tax return.

The "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal" issued by the Staff of the Joint Committee on Taxation on September 8, 2009 provided further insight. As to the estoppel issue, the report stated that a beneficiary "should not be estopped from claiming a basis different from the value determined by an executor for estate tax purposes where the taxpayer did not participate in the executor's determination." In addition, the report took the position that the basis would be the value "*reported* for transfer tax purposes" (i.e., the value placed on the gift or estate tax return) and not the value ultimately determined in an estate or gift tax audit. The report says that would have "the salutary effect of encouraging a more realistic value determination in the first instance." The report adds that the salutary effect would be lost if there were a relief mechanism in case the basis used by transferees differed from the fair market value "ultimately determined for transfer tax purposes." In contrast, the Greenbook says that the basis would be "the value of that property for estate tax purposes" and that regulations would address "the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.") Finally, the report clarified that under the proposal, the basis of the recipient can be no *greater than* the value determined for estate and gift tax purposes, but the recipient could claim a lower value to avoid accuracy-related penalties under §6662 if the transferor overstated the value for transfer tax purposes.

This proposal was repeated in the Administration's Revenue Proposals for Fiscal Years 2011-2016 but the Proposals made clear that the value as finally determined for estate tax purposes would apply, not just the reported value. A

legislative proposal of that approach was contained in section 6 of the Responsible Estate Tax Act in 2010 (S. 3533 and H.R. 5764),in the December 2010 "Baucus Bill, and in section 5 of "The Sensible Estate Tax Act of 2011" legislative proposal (H.R. 3467).

(2) *Legislative Provision in Extension of Highway Trust Fund.* The basis consistency provisions for property received from a decedent (but not the consistency proposals for gifts) were enacted as Section 2004 of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, which extends funding of the "Highway Trust Fund" through October 29, 2015 and which was signed into law July 31, 2015 (the "Act").

New Section 1014(f). Section 2004 of the Act adds new §1014(f), which provides that the basis of property to which §1014(a) applies (i.e., property acquired from a decedent) shall not exceed the final value determined for estate tax purposes (and there are detailed provisions governing when the tax is finally determined), or if the final value has not been determined, the value provided in a statement to the decedent's recipients. This provision applies only to property "whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11… on such estate." [Observe that if there is no estate tax because of the marital or charitable deduction and therefore inclusion of the asset in the estate does not increase the liability for the estate tax imposed on such estate—because the estate tax liability "on such estate" remains at zero—the basis consistency provision of §1014(f) apparently does not apply. There is no similar exception, however, in the information reporting requirements in new §6035, discussed immediately below. The exception would apply to the penalty under new §6662(k), because it references §1014(f), but there is no similar exception to the penalties under §§6721 and 6722). Therefore, penalties may be imposed for failure to file the information statements required under §6035 by the due date of the tax return even though no penalties may apply for failing to file the return itself in a timely manner (because the failure to file penalty under §6651 is based on a percentage of the tax due).]

Information Reporting Requirements. If the estate is required to file an estate tax return under §6018(a), the executor is required to report valuation information to both the recipients (i.e., "each person acquiring any interest in property included in the decedent's gross estate") and the IRS. §6035(a)(1). [Observe that the information reporting requirement does not apply to estates that file estate tax returns merely to elect portability, but that are not otherwise required to file returns. While Treas. Reg. §20.2010-2(a)(1) provides that an estate that elects portability will be "considered" to be required to file a return under §6018(a) for purposes of the timely filing requirement to elect portability, that provision only applies for purposes of determining when a return must be filed to make the portability election, and not when a return is actually required to be filed under §6018. Also observe that the broad description of the recipients who are entitled to receive information may indicate that the information must be provided to all current and potential future trust beneficiaries for assets in revocable trusts or for estate assets that pass to trusts.] Such statements must be furnished at the time prescribed in regulations, but no later than 30 days after the return's due date, including extensions (or 30 days after the return is filed, if earlier).

§6035(a)(3)(A). If valuation or other adjustments are made after the statements are furnished, supplemental statements must be furnished within 30 days of the date of the adjustment. §6035(a)(3)(B). Regulatory authority is granted to provide implementation details, including rules for situations in which no estate tax returns are required, or if the surviving joint tenant or other recipient has better information than the executor.

Penalties for Inconsistent Reporting. Section 2004(c) of the Act amends §6662 to provide that the accuracy-related penalties on underpayments under §6662 apply if a taxpayer reports a higher basis than the estate tax value basis that applies under new §1014(f).

Penalties for Failure to Provide Information Returns and Statements. Penalties for the failure to file correct "information returns" or "payee statements" are provided in §§6721 and 6722, respectively. The penalty is generally $250 ($100 for returns or statements required before 2016), with a maximum penalty for all failures during a calendar year of $3,000,000 ($1,500,000 for returns or statements required before 2016). If the failure to furnish the required information return or statement is "due to intentional disregard" of the requirement to furnish the return or statement, the penalty is $500 ($250 for returns or statements required before 2016) or if greater, "10 percent of the aggregate amount of the items required to be reported correctly." §§6721(e) and 6722(e). ***Thus, the penalty can be quite large for intentionally disregarding the requirement to file the information returns or statements.*** Section 6724(a) provides a waiver of the penalties imposed by §§6721-6723 if the "failure is due to reasonable cause and not … willful neglect." (Section 6723 imposes a smaller penalty for the failure to comply with "a specified information reporting requirement," but that section does not apply. The regulations to §6723 provide that the section applies only to certain specifically listed information requirements, none of which is the information required under new §6035. Treas. Reg. §301.6723-1.)

The §§6721 and 6722 penalties are extended to information returns and statements to estate recipients required under new §6035. Section 2004(b)(2) of the Act revises the definitions of "information return" and "payee statements" (as those terms are used in §§6721 and 6722) to include statements to be filed with the IRS as "information returns" and statements to be provided to estate recipients as "payee statements," by amendments to §6724(d). (Those definitions apply "for purposes of this part" (which refers to Part I of Subchapter B of Chapter 68—including §§6721 and 6722).

Effective Date. The amendments to §§1014(f), 6035 and 6724(d) described above "shall apply to property with respect to which an estate tax return is filed after the date of the enactment of this Act." (Section 2004(d) of the Act.) This means that the information returns and recipient statements (and penalties for failure to furnish such statements) apply for returns actually filed after July 31, 2015, even for decedents who died before July 31, 2015. For decedents who died long enough ago that the due date for filing the estate return has already passed, the Act literally says that the information return and recipient statements were due on the due date of the return—even though that was before the Act was even passed, in effect imposing a retroactive due date. In addition, penalties are

applicable (retroactively, in effect, if the due date for the return has already passed). This retroactive application of the Act may apply in various situations. For example, the executor may have delayed filing the estate tax return for an estate in which sufficient assets pass to the surviving spouse or charity or to a QTIP trust (the QTIP election can be made on the first return that is filed, even if it is filed late, Treas. Reg. §20.2056(b)-7(b)(4)) so that no estate tax is due for the decedent's estate. Hopefully, relief will be provided by the IRS for those "retroactive due date" situations. In particular, it would seem that the 10% penalty for intentional disregard of the requirement of filing the information returns and recipient statements under §§6721(e) and 6722(e) would not apply when the requirement to make such information returns and statements was not even known on the date that the Act now says they were due.

Extension of Due Date for Information Reports. Notice 2015-57 extends the due date for filing information reports under new §6035 to February 29, 2016. "This delay is to allow the Treasury Department and IRS to issue guidance implementing the reporting requirements of section 6035." The Notice provides that information reports should not be filed "until the issuance of forms or further guidance."

Practical Administration and Fairness Issues. Carol Harrington pointed out several years ago that this provision is unfair because the beneficiary may have had no input in the estate tax audit negotiations, and the executor may have "traded off" on the valuation of various assets. With this provision, the executor will have to consider the effect of audit negotiations on the basis of assets received by the various individual beneficiaries.

In many estates, the executor will not know 30 days after the estate tax return is filed what assets will be passing to particular estate beneficiaries. In that case, the executor may need to provide the valuation information to every estate beneficiary about all estate assets except for beneficiaries receiving only specific bequest s of particular property. Executors may be reluctant to provide full information about all estate assets to beneficiaries who are only entitled to receive a general bequest that may represent a fairly small portion of the estate.

One wonders why there is a necessity of providing a statement to the IRS about values of assets reported on an estate tax return when the estate tax return itself has already been filed with the IRS. Presumably, the only point of providing a statement to the IRS would be to give the IRS information about assets passing to particular beneficiaries in case the IRS will track the basis information that may be reported by those beneficiaries on their future income tax returns. The identification of particular assets passing the particular beneficiaries will not be available, however, for many estates by 30 days after the estate tax return is filed (and obviously before an estate tax closing letter is received).

Regulations will need to provide many implementation details. For example, must information statements be provided to beneficiaries receiving specific cash bequests? Must the information statement be provided to a beneficiary who is also the executor?

Must the information be provided for income in respect of a decedent items or for appreciated property acquired by the decedent by gift within one year of death that is left to the donor? Those items receive no basis step-up at death; they are exceptions from §1014(a) [see §1014 (c) and §1014(e)] so the basis consistency provisions do not apply to those items. Information reporting about the estate tax values of those items would at best be useless and may actually create confusion for beneficiaries (leading them to believe they may be able to use the estate tax value as the basis).

Furthermore, one wonders if the revenue raised (the Joint Committee on Taxation estimates a $1.542 billion revenue impact between 2015 and 2025) will be less than the additional expense that will be incurred by estates in complying with the information reporting measures within 30 days after estate tax returns are filed.

2. TREASURY-IRS PRIORITY GUIDANCE PLAN

a. **Overview.** The Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015 was released on July 31, 2015; it is available at http://www.irs.gov/pub/irs-utl/2015-2016_pgp_initial.pdf. Two items from last year's list for Gifts, Estates and Trusts have been eliminated because of the issuance of final regulations: final regulations under §67 and the final portability regulations.

The 2015-2016 Plan includes the new item in last year's Priority Guidance Plan: "Revenue Procedure under §2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability." This will likely make clear that QTIP trusts can be used in connection with portability planning even if the QTIP election is not needed to reduce the estate tax in the first decedent's estate, despite the provisions of Revenue Procedure 2001-38. (Rev. Proc. 2001-38 appears to give estates the option of electing to treat the unneeded QTIP election as null and void; a revenue procedure announcing the Service's administrative forbearance cannot negate an election clearly authorized by statute.) The preamble to the portability final regulations (T.D. 9725) addresses the effect of the portability election on the application of Rev. Proc. 2001-38 in a cursory fashion: "The Treasury Department and the IRS intend to provide guidance, by publication in the Internal Revenue Bulletin, to clarify whether a QTIP election made under section 2056(b)(7) may be disregarded and treated as null and void when an executor has elected portability of the DSUE amount under section 2010(c)(5)(A)." (The preamble does not mention that an example in the temporary regulation regarding the application of the exception from having to report to values for certain property applies in a situation involving a trust for which a QTIP election was made, Reg. §20.2010-2T(a)(7)(C) Ex.2, was revised to omit the reference to a QTIP election.). Planners had been hopeful that this issue would be clarified in connection with the finalizing of the portability regulations by June 15, 2015 (which is the only new item on this year's list of projects in the Gifts and Estates and Trusts section of the Priority Guidance Plan for 2014-2015). One wonders why this guidance regarding Rev. Proc. 2001-38 is taking so long. Perhaps the IRS wants to craft a solution dealing with situations in which the portability election is made and QTIP assets decline in value by the time of the surviving spouse's death to keep the executor from being able to invoking Rev. Proc. 2001-38 to keep the assets from being included in the surviving spouse's gross estate in order to avoid a step-DOWN in basis under §1014.

There are four new items in the 2015-2016 Plan:

> "1. Guidance on qualified contingencies of charitable remainder annuity trusts under §664.
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> …
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> 3. Guidance on basis of grantor trust assets at death under §1014.
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> …
>
> 5. Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872.
>
> …
>
> 8. Guidance on the gift tax effect of defined value formula clauses under §2512 and 2511."

As to the new item regarding the *basis of grantor trust assets* under §1014, some commentators take the position that the deemed change of ownership for income tax purposes at the grantor's death (from the grantor to the trust) constitutes the receipt of property from a decedent for purposes of §1014, and that there should be a basis step up even though the assets are not included in the gross estate. *See* Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. TAX'N 149 (Sept. 2002). The IRS recently added to its "no-ruling" list that it will not issue rulings as to "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code." Rev. Proc. 2015-37. See Item 2.d.(1) below for a discussion of that no-ruling position and related authorities.

As to the new item dealing with the *valuation of promissory notes*, some examining agents have taken the position in gift tax audits that promissory notes bearing interest at the AFR should not be treated as being worth the face amount of the note, but have been reluctant to allow discounts in valuing such notes for estate tax purposes. (Section 7872(i)(2) specifically authorizes the issuance of regulations addressing the valuation of notes for estate tax purposes in light of §7872. Proposed Regulation §20.7872-1 addresses the valuation of a "gift term loan" for estate tax purposes, but that regulation has never been finalized.)

The new item regarding *defined value formula clauses* suggests that the IRS will eventually issue regulations regarding the effect of defined value formula clauses, despite its losses in the *McCord, Christianson, Petter, Hendrix* and *Wandry* cases.

These three issues all relate to sales to grantor trusts, suggesting that issues related to sales to grantor trusts are major "radar screen" issues for the IRS.

Other items in the Priority Guidance Plan carried over from prior years include:

- Final regulations under §2032A regarding imposition of restrictions on estate assets during the six month alternate valuation period (this project first appeared in the 2007-2008 plan and proposed regulations were published in November 2011);

- Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against an estate (this project first appeared in the 2008-2009 plan);
- Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP (for example, the allocation of GST exemption to trusts created under a GRAT at the end of the initial GRAT term) (this project first appeared on the 2012-2013 plan);
- Final regulations under §2642(g) regarding extensions of time to make allocations of the GST exemption (this project first appeared in the 2007-2008 plan and proposed regulations were published in April, 2008);
- Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships (this item first appeared in the 2003-2004 plan) (**there are indications that Treasury and IRS officials are currently working on this proposal, so proposed regulations might conceivably be issued at some point during 2015**); and
- Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates (this item first appeared in the 2009-2010 plan to implement the provisions of the "HEART Act" of 2008; this is consistently referred to by Treasury and IRS personnel as a top priority, but the implementation of what amounts to a transfer tax on transferees or their estates is complicated).

b. **Items of Highest Priority**. Cathy Hughes (with the Treasury Department) provided insight at the 2015 Spring ABA Tax Section meeting as to the regulation projects impacting estate planners with the highest priority. Projects that she mentioned include: (1) Final portability regulations (the temporary regulations expired June 15, 2015); (2) Guidance under the ABLE Act allowing states to create "Section 529-type" accounts for the disabled; (3) Final regulations regarding basis rules for term interests in charitable remainder trusts (which were issued on August 11, 2015); (4) Guidance regarding the §2801 tax on gifts by certain expatriates to U.S. citizens and residents (this has been a "high priority" for several years); and after that guidance is issued (5) Section 2704 proposed regulations. (The preceding information is based on a summary of the ABA Tax Section meeting by Diane Freda. Freda, *Guidance on Material Participation For Trusts, Estates May Emerge in Stages*, BNA Daily Tax Report (May 12, 2015).) All of those projects have been issued except for item (5)—new §2704 proposed regulations.

   At the ABA Tax/Real Property Probate and Trust Law Section Joint Meeting on September 18, 2015 Cathy Hughes indicated that the IRS/Treasury is still working on the Section 2704 proposed regulations. They are "getting closer" but they cannot predict when the new rules will be issued. She gave no further indications regarding the scope of the rules or their effective date. This summary suggests that the §2704 regulations will not be issued within the next several months but might conceivably be issued this fall or in 2016.

c. **Section 2704 Project**.

(1) *Overview.* Section 2704(b)(4) gives the Treasury broad authorization to issue regulations that would disregard certain "other restrictions" in determining the value of an interest in a corporation or partnership transferred to a family member if the restriction "does not ultimately reduce the value of such interest to the transferee." IRS and Treasury officials hinted about eight years ago that they were close to issuing such a proposed regulation (reflecting a §2704 guidance project that was placed on the IRS/Treasury Priority Guidance Plan in 2003), but President Obama's first budget proposal included a revenue proposal to revise §2704, and the §2704 regulation project was put on hold pending the possible passage of such legislation that might provide legislative support for the positions the new proposed regulation might take. Not a single bill was ever introduced addressing the legislative proposal, however, and the §2704 legislative proposal was omitted from the President's budget proposal released in February 2012.

IRS and Treasury officials have indicated that the §2704 regulation project is proceeding. Cathy Hughes, a Treasury official, had some comments about the §2704 regulation project at the recent ABA Tax Section meeting. The proposed regulation may have a dramatic impact on the valuation of interests in closely-held corporations or partnerships that are transferred to family members—and the proposed regulation might conceivably be effective when the regulation is finalized retroactive to the date of the proposed regulation.

(2) *Section 2704 Statutory Background*. Section 2704 was enacted in 1990 as a part of Chapter 14. The goal in particular was to limit discounts for certain family partnership or LLC interests that are transferred to family members. Section 2704(b) is titled "Certain Restrictions on Liquidation Disregarded." It provides that any "applicable restriction" is disregarded in valuing an interest in a corporation or partnership that is transferred to a family member if the transferor and family members control the entity. An "applicable restriction" is any restriction that (i) effectively limits the ability of the corporation or partnership to liquidate, and (ii) the restriction lapses (entirely or partially) after the transfer OR the transferor or family members can remove the restriction (entirely or partially), but an "applicable restriction" does not include "any restriction imposed, or required to be imposed, by any Federal or State law" (or commercially reasonable restrictions imposed by unrelated persons in a financing transaction).

Section 2704(b)(4) includes broad legislative authority for the IRS to issue regulations that would disregard "other restrictions":

> "The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee."

The title to §2704(b) is "Certain Restrictions on Liquidation Disregarded." The authorization of regulatory authority in §2704(b)(4) does not specifically limit the

regulations to "other liquidation restrictions" but merely refers to "other restrictions." Does this provide legislative authority for regulations limiting discounts for reasons other than merely disregarding liquidation restrictions despite the title of §2704(b)?

(3) *Significance of State Law Exception.* The exception for "any restriction imposed, or required to be imposed, by any Federal or State law" is very important. The "state law" exception is clearly integrated into the existing regulations.

> "An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction.... Ability to remove the restriction is determined by reference to the State law that would apply but for a more restrictive rule in the governing instrument of the entity.... A restriction imposed or required to be imposed by Federal or State law is not an applicable restriction." Treas. Reg. §25.2702-2(b).
>
> "(c) *Effect of disregarding an applicable restriction.*—If an applicable restriction is disregarded under this section, the transferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined under the State law that would apply but for the restriction." Treas. Reg. §25.2704-2(c).

The exception for restrictions imposed by State law has dramatically reduced the applicability of §2704 to partnership and LLC transfers. Many state legislatures have revised limited partnership and LLC laws after the passage of §2704 to provide various limitations on the rights of limited partners or LLC members to make transfers under default rules that apply unless the partnership or operating agreement specifically overrides those default rules.

(4) *Possible Scope of New §2704 Proposed Regulation*. Cathy Hughes said that the scope of what the new regulations might include are indicated by the §2704 legislative proposal (last included in the Fiscal Year 2013 Greenbook, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals" dated February 2012). (This suggests that the new proposed regulations may include many of the items that were being considered eight years ago. The Treasury presumably suggested the §2704 legislative project to the Obama administration to support the provisions that it wanted to include in its new regulations.)

The §2704 legislative proposal in the Greenbooks for the Obama administration, ending with the 2013 Fiscal Year Greenbook, includes five items. The new §2704 regulation may include some or all of these subjects.

(i) *Additional "Disregarded Restrictions*." An additional category of restrictions ("disregarded restrictions," which are in addition to the liquidation restrictions addressed in §2704) may be disregarded in determining the value of interests in "family-controlled entities" (observe, this is not limited just to partnerships and LLCs) that are transferred to family members. What are those additional restrictions? They are "to be specified in regulations." Transferred interests would be valued by substituting for "disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to

liquidate that holder's interest that are more restrictive than a standard to be identified in regulations. "

(ii) *Assignee Interests*. Restrictions on a transferee being able to become a full-fledged partner (or member of an LLC) would be a disregarded retriction.

(iii) *Third Party Involvement in Removing Restrictions*. Section 2704(b)(2)(B)(ii) says that one of the general requirements of an "applicable restriction" is that the transferor or family members can remove the restriction. (The Greenbook proposal generally retains this family-removal requirement with respect to "disregarded restrictions.") The Fifth Circuit in the *Kerr* case reasoned that §2704 did not apply to the partnership in that case because charities had small limited partnership interests, and all partners had to consent to removing restrictions; thus, the family acting alone could not remove the restrictions. *Kerr v. Commissioner*, 292 F.3d 490 (5th Cir. 2002). Under the legislative proposal, "certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family."

(iv) *Safe Harbor*. The statute would provide regulation authority that would include "the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met."

(v) *Marital and Charitable Deduction*. The legislation would include provisions dealing with the interaction of the marital and charitable deductions for transfer tax purposes. Therefore, if an interest is valued higher than its actual fair market value for transfer tax purposes, the higher value might also be applied for marital deduction and charitable deduction purposes (a taxpayer-friendly provision).

Richard Dees (Chicago, Illinois) wrote a 29-page letter to the Assistant Secretary of Tax Policy in the Treasury Department and to the Commissioner of the Internal Revenue Service on August 31, 2015, in which he maintains that if the regulation implements the provisions in the statutory proposal, the regulation "would be invalid as contrary to the origin, purpose and scope of the current statute." The letter provides a detailed summary of the statutory provisions in §2704, the legislative history behind §2704, and case law interpreting §2704 to support his position. Some of his reasoning is that the origin and intent of §2704 was "only to disregard liquidation provisions and other provisions of organizational documents that lowered the value of interest in a family business for transfer tax purposes below what would occur under state law if those provisions were not in the documents." He argues that §2704(b) only empowers the IRS to *disregard* certain restrictions in family entity organizational documents, but not to replace those disregarded provisions with IRS-invented alternatives "that would make the valuation of minority interests in a family business the same as if family attribution applied;" instead the balance of the provisions in the documents that are not disregarded and provisions supplied by the operation of state law would be considered in valuing the transferred interest.

(5) *Effective Date*. Treasury regulations are typically effective on the date final regulations are issued. At least several years typically lapse from the time proposed regulations are issued until the regulations are finalized. In very limited situations, proposed regulations provide they will be effective when finalized retroactive back to the date of the proposed regulations. For example, the proposed regulations regarding the income tax effects of private annuities issued in 2006 take that approach (and interestingly, those regulations still have not been finalized, nine years after the proposed regulations were issued, *see* REG-141901-05k proposing changes to Reg. §§1.72-6(e) & 1.100(j)). The initial "anti-Kohler" proposed regulations that were issued in 2008 also took that "retroactive effect" approach, but the revised proposed regulation issued in 2011 dropped that harsh effective date provision. *See* Prop. Treas. Reg. §20.2032-1(f). Cathy Hughes suggested at the ABA Tax Section meeting that the Treasury and IRS are still considering what should be the appropriate effective date of the proposed regulation.

(6) *Legislative History*. Some planners have expressed concern that the proposed regulation may limit the availability of minority and marketability discounts for transfers involving family-controlled entities. *See* Freda, *Guidance on Material Participation For Trusts, Estates May Emerge in Stages*, BNA Daily Tax Report (May 12, 2015) (summarizing comments of Richard Dees). The legislative history (the 1990 Conference Report) makes clear that Chapter 14 was not intended to "affect minority discounts or other discounts available under [former] law." The Senate's discussion of the former law and the impact of Chapter 14 is rather emphatic.

> "The value of property transferred by gift or includable in the decedent's gross estate generally is its fair market value at the time of the gift or death. Fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treas. Reg. sec. 20.2031-1(b)). This standard looks to the value of the property to a hypothetical seller and buyer, not the actual parties to the transfer. Accordingly, courts generally have refused to consider familiar relationships among co-owners in valuing property. For example, courts allow corporate stock to be discounted to reflect minority ownership even when related persons together own most or all of the underlying stock.
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> *The bill does not affect minority discounts or other discounts available under present law.*
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> *. . . the bill does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally* in all items of income, deduction, loss and gain in the same proportion *(i.e.*, straight-up allocations)." (136 Cong. Rec. § 15679, 15681 (October 18, 1990) (emphasis added)).

Perhaps the existence of this legislative history is the reason that the IRS beginning in 2009 sought legislative changes to §2704 before issuing its new proposed regulations.

d. **Surprises.** The IRS has recently released several items of interest for which there was no warning in the Priority Guidance Plan.

(1) *Basis of Assets Transferred to Grantor Trust at Grantor's Death.* Some commentators have taken the position that assets in the grantor trust that were transferred to the trust from the grantor should receive a basis step-up at the grantor's death. *See* Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 49 (Sept. 2002). The article observes that the basis step-up under §1014 is not limited to assets included in a decedent's gross estate for estate tax purposes. While §1014 provides for a basis adjustment to the date of death value for property included in a decedent's gross estate, there are various other situations in which property that is "acquired from a decedent" will receive a basis adjustment, detailed in nine subsections of §1014(b). Section 1014(b)(9) is the "included in the decedent's gross estate" section, but other subsections are far more general, including subsection (b)(1) which simply refers to "property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." (An example of an asset not in a decedent's gross estate for estate tax purposes that receives a basis adjustment is foreign property left from a foreign person to a U.S. person—that property in the hands of the U.S. person has a basis equal to the date of death value even though it was not in the decedent's gross estate for U.S. estate tax purposes. Rev. Rul. 84-139; PLR 201245006.) The Blattmachr, Gans & Jacobson article reasons "a good argument can be made that assets held in such a trust should be viewed as passing as a bequest or devise when the trust ceases to be a grantor trust at the moment of death." Up until the grantor's death, the assets have been treated as being owned by the grantor for income tax purposes.

The IRS has added to its "no-ruling" list that it will not issue rulings as to "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code." Rev. Proc. 2015-37; *see* Diane Freda, *IRS No-Rule on Basis in Grantor Trust Sales Reflects Clash of Opinions*, BNA Daily Tax Report (June 19, 2015) (noting that tax attorney Alan Lederman observes that there are conflicting private rulings; PLR 201245006 concludes that a basis step-up would be available for the grantor trust assets at the grantor's death but CCA 200937028 reasons that "since the decedent transferred the property into the trust," there is no basis step-up under §1014). Jonathan Blattmachr's reaction to the no-ruling position is that the IRS "doesn't like the result of stepped up basis, and isn't going to assist taxpayers in reducing their tax bill—even if it is legitimate." *Id*.

(2) *Closing Letters Will Be Issued Only on Request*. In a June 16, 2015 update to the "Frequently Asked Questions on Estate Taxes" on the IRS website, the IRS indicates that for all estate tax returns filed on or after June 1, 2015, estate tax closing letters will be issued only upon request by the taxpayer. Taxpayers are asked to wait at least four months after filing the estate tax return to make the closing letter

request "to allow time for processing." Apparently, this changed procedure is made in light of budgets cuts to the IRS and in light the fact that a closing letter does little good for returns filed solely to elect portability (because the statute of limitations on that return does not lapse until the statute of limitations lapses on the surviving spouse's return). Estates that owe estate taxes will almost routinely want to request the closing letter before making estate distributions.

This notice on the IRS website says that for returns filed before June 1, 2015, estates can expect to receive a closing letter about 4 to 6 months after the return is filed unless the return is selected for examination or reviewed for statistical purposes.

At the ABA Tax/Real Property Probate and Trust Law Section Joint Meeting on September 18, 2015 Cathy Hughes (with the Treasury Department Office of Tax Policy) suggested that an alternative to requesting a closing letter is to request a transcript for the estate tax return. A particular code on the transcript indicates that the examination is complete (and a closing letter historically would have been issued). At some point, the regulations may state affirmatively that the transcript is the equivalent of a closing letter. The Frequently Asked Questions website at IRS.gov will be updated in the near future with this information.

3. Overview of Estate Planning Practices in the Current Environment

a. **Stability of Estate Transfer Tax Laws**. The American Taxpayer Relief Act of 2012 ("ATRA") provides for permanent provisions in the transfer tax area, without any further phase-ins. That stability did not exist from 2001-2012.

b. **Small Percentage of Population Subject to Transfer Taxes**. Estimates are that with a $5 million indexed gift and estate exemption ($5.43 million in 2015, anticipated to be $5.45 million in 2016) only 0.14% of Americans who die each year will owe any federal estate tax (or about 2 out of every 1,000 people who die). The $5 million indexed gift exemption also means that many individuals have no concern with lifetime gifts ever resulting in the payment of federal gift taxes. There are still wealthy clients, though, and the wealthy are getting wealthier. (The Dow Jones average increased 26½% in 2013 and 7½% in 2014.)

c. **Cannot Ignore GST Tax**. Even low to moderate-wealth individuals cannot ignore the GST tax. Without proper allocation of the GST exemption (also $5 million indexed), trusts created by clients generally will be subject to the GST tax at the death of the beneficiary. (Sometimes that will occur by automatic allocation, but the planner must be sure that proper GST exemption allocation is made to long-term trusts even though the purpose of the trusts is not to save transfer taxes.)

d. **Fear of Estate Tax Uncertainty Is No Longer Driving Clients to Estate Planners**. Prior to 2012, Congressional action (or inaction) was driving clients to estate planning practices to make changes to estate plans. That is no longer happening. Estate planning practitioners will need to be more proactive in communicating with clients the importance of estate planning matters.

e. **Increased Relative Importance of Income Tax Issues**. At a time when the estate and gift tax for many Americans is zero, income tax planning is more significant than

transfer tax planning. Even for couples with about $11 million of assets, little or no federal estate taxes may be due at the surviving spouse's death. Achieving basis step-up at each of the spouse's deaths may be very important. The ordinary income tax rate

(39.6%) is about the same as the federal estate tax rate (40%). Even the capital gains rate (23.8% including the 3.8% tax on net investment income), when combined with state income taxes, may approach the federal estate tax rate.

f. **Routinely Using Traditional Credit Shelter Trust/Marital Deduction Planning is Out Other Than For Very Wealthy Clients**. The days of automatically using traditional credit shelter trust/marital deduction planning for all clients with assets more than one exemption amount are gone. Some planners believe that planning for the $10 million estate is *more* difficult than planning for the $100 million estate, because of the balancing required between various alternatives, depending on future events, for the $10 million estate. There may be situations in which credit shelter trust planning is appropriate for the $10 million and under estates, but only with careful consideration of a wide variety of factors.

g. **Portability Approach Has Become More Predominant**. Unless strong reasons exist to use credit shelter trusts in $10 million and under estates, an approach of using portability to take advantage of the first spouse's estate exemption will become more predominant. The surviving spouse has both spouses' exemptions to cover estate taxes, but a basis step-up is achieved at both spouses' deaths. Some of the factors for favoring the creation of a credit shelter trust at the first spouse's death include if there is (i) a likelihood or significant possibility of substantial appreciation of estate assets after the first spouse's death, (ii) a state estate tax, (iii) a blended family situation, (iv) a younger client scenario (in which remarriage of the surviving spouse is likely), (v) a situation in which the couple wants to use trusts after the first spouse's death and wants to have both the surviving spouse and descendants as discretionary beneficiaries of the trust.

Some planners refer to this as the "do no harm" approach. A fairly good tax plan is in place for couples with estates under $10 million before the client comes to the planner's office—no estate tax would likely occur at either spouse's death (although future appreciation may conceivably result in some estate taxes at the second spouse's death) and there is a basis step-up at both spouses' deaths.

h. **Planning Is More Difficult for Planners**. Tax simplification measures that permit additional planning alternatives, often make planning more difficult for planners, because the planner must review the appropriateness of each possible alternative. That has certainly happened with portability. Many attorneys report that discussing the portability alternatives with clients and the various factors impacting the decision often takes 20-30 minutes or more, and at the end of the discussion the client is often totally perplexed about what to do. Even after a decision is made, the planner must document the discussion, including the factors that were considered and the reason that the client made the decision that was made.

Twenty years later, facts may occur that mean that an alternative course of action would have been preferable, and the planner needs to be able to document that the client made an informed, reasoned decision.

i. **Transfer Planning Still Important for Wealthy Families.** Transfer planning is still important for clients who will be subject to estate taxes (individuals with assets over about $5.5 million and couples with assets over about $11 million). An initial step is to focus on strategies that use no gift exemption or that leverage the use of gift exemption (therefore, leaving the client with estate exemption so that the client can own low basis assets at death, covered by the exemption, to achieve a basis step-up for those assets). Low-interest loans, GRATs, leveraged GRATs, and sales to grantor trusts (see paragraph k below) are all strategies that may accomplish those goals. GST planning is very important; with appropriate planning a large portion of even very large estates can be left in a GST exempt manner. See paragraph k and Item 5.k below. Special more sophisticated transfer planning strategies may also address ways to minimize the effect of losing basis adjustments at the transferor's death. See Item 7 below.

   Discounts for interests in partnerships and LLCs may at some point be diminished. The rumored §2704 regulations are making their way up the bureaucratic approval process. *Transfer planning with these interests might be accelerated*; the issuance of those proposed regulations may still take years, but it could happen sometime this year.

   In the unlikely event that the GRAT proposal in the 2016 Fiscal Year Plan Greenbook should pass, new GRATs would effectively be eliminated. (The remainder interest would have to be valued at the greater of 25% of the value contributed or $500,000, but not to exceed the value contributed, and the grantor could not purchase assets from the GRAT. The proposal would apply to GRATs created after the date of enactment.)

j. **Be Very Careful Before Making Lifetime Gifts of Low Basis Assets**. Estate tax savings result from gifts by excluding the future appreciation in the donated assets from the donor's gross estate. The estate tax savings are offset by the loss of a basis step-up if the client dies no longer owning the donated property. For example, a gift of a $1 million asset with a zero basis would have to appreciate to approximately $2,470,000 (to a value that is 247% of the current value) in order for the estate tax savings on the future appreciation ($1,469,135 x 40%) to start to offset the loss of basis step-up ((2,469,135 x 23.8% for high bracket taxpayers). The required appreciation will be even more if there are also state income taxes on the capital gains.

k. **Grantor Trust Planning Still Advantageous**. Grantor trust planning continues to be very desirable for clients with large estates who are interested in transfer planning strategies to reduce estate taxes. Even for more modest estates, grantor trusts afford substantial flexibility. Advantages of using grantor trusts include:

   > (i) the grantor pays the income taxes on the trust income so the trust can grow faster and the tax payments further reduce the grantor 's taxable estate (studies have shown that this is the most important factor in the long-term effectiveness of transfer planning strategies—even more important than discount or freeze planning aspects of transfer planning strategies);
   >
   > (ii) the grantor can sell additional assets to the trust in return for a low-interest note without gain recognition on the sale (and all of the appreciation can be in a GST exempt trust if GST exemption is allocated to the initial gift to the trust); and
   >
   > (iii) the grantor has the flexibility to purchase back trust assets, in case the grantor prefers having assets that were transferred to the trust or if the grantor wants to reacquire low basis

assets so they will receive a basis step-up at the grantor's death (the purchase should be made with cash or high basis assets because the income tax effects of purchasing low basis assets in return for a note are not certain).

Examples of the flexibilities of grantor trusts are that the grantor can keep the ability to end the grantor trust status when desired and distributions can be made to the grantor's spouse to pay the income taxes if desired (assuming the spouse is a discretionary beneficiary).

Analytical studies of the financial impact of various strategies demonstrate that sales to grantor trusts can be incredibly efficient in accomplishing wealth transfer, particularly accomplishing wealth transfer in a many that is largely GST exempt. (See Item 5.k below.) In several recent cases, the IRS has taken that position that §2036 applies to sales to grantor trust transactions. Planners should take careful steps to create the best defense around a §2036 argument.

l. **Undoing Prior Planning Strategies**. A number of clients will want to engage in planning to "undo" the effects of prior planning transactions if the client will not face estate taxes with the larger exemptions and does not want to lose the basis step-up at each spouse's death. This includes avoiding the funding of bypass trusts under the wills of clients who die without updating their wills, causing previously transferred low-basis assets to be included back in the donor's gross estate, and undoing prior discount planning. See Item 6 below.

m. **Basis Adjustment Planning**. Planning to leave open the flexibility to cause trust assets to be included in the gross estate of a trust beneficiary if the beneficiary has excess estate exemption, to permit a basis adjustment at the beneficiary's death without generating any added estate tax, is increasingly important. Possible strategies include planning for the flexibility to make distributions to the beneficiary (either pursuant to a wide discretionary distribution standard or under the exercise of a non-fiduciary limited power of appointment), to have someone grant of general power of appointment to the beneficiary, to use of a formula general power of appointment, or to trigger the Delaware tax trap (by the exercise of a limited power of appointment to appoint the assets into a trust of which a beneficiary has a presently exercisable general power of appointment). See Item 7 for a more detailed discussion of these strategies. Perhaps this type of planning is given a boost by the statement in President Obama's tax proposal that the "trust loophole" under §1014 is "perhaps the largest single loophole in the entire individual income tax code."

n. **Trust Planning**. Planning to use trusts will continue to be important, if for no other reason, for the non-tax advantages of trusts (including planning for long-term management and creditor protection or "divorce" protection for beneficiaries). However, these advantages must be balanced against the greater administrative and income tax costs for trusts. Trust structuring should incorporate planning for flexibility provisions to react to future conditions. See Item 4 below. Powers of appointment are becoming increasingly popular for various reasons in facilitating future flexibility.

o. **Estate and Trust Distribution Planning.** Estates and trust reach the maximum income tax bracket at only $12,300 in 2015; if distributions are made that "carry out" income to the beneficiaries instead, they may be in much lower brackets. (For example, married individuals do not reach the top bracket until they have taxable

income in 2015 of $464,850.) This planning is particularly important for capital gains; trusts with income taxable income over $12,300 are taxed on capital gains at 23.8% (not counting any state income taxes). Individuals may have a 15% or even lower rate on capital gains. Increasing attention is devoted to causing capital gains to be in distributable net income (DNI) so that distributions can result in capital gains being subject to the15% or even lower rates. Ways of causing capital gains to be in DNI are described in Reg. §1.643(a)-3(b). An example clause giving the trustee discretion to utilize the flexibilities afforded by the regulation to cause capital gains to be in DNI is as follows:

> The Trustee may allocate realized short term capital gains and/or realized long term capital gains to either trust income or trust principal, and such gains shall be includable in distributable net income as defined in I.R.C. § 643 and the regulations thereunder (1) to the extent that such gains are allocated to income and distributed to the trust beneficiary; or (2) if such gains are allocated to principal, to the extent they are consistently treated as part of a distribution to the trust beneficiary, actually distributed to the trust beneficiary, or used by the Trustee in determining the amount distributable to the trust beneficiary.

Gregory Gadarian, *Including Capital Gains in DNI,* ACTEC 2014 Fall Meeting of Fiduciary Income Tax Committee.

This does not mean that trust distributions should automatically be made to reduce the trust's taxable income below $12,300. That may frustrate the reasons the trust was created. But trustees may need to consider income tax planning in making decisions of what is in the best overall interest of the trust and beneficiaries in accordance with the distribution standard in the trust instrument.

Trusts with business income will focus on whether they can satisfy the material participation requirements so that the resulting non-passive business income is not subject to the 3.8% tax on net investment income.

p. **State Estate Taxes**. Clients in states with state estate taxes will continue to need tax planning to minimize state estate taxes, which can be very significant. Twenty-one states and the District of Columbia have state estate taxes. New York's experience may be followed in other states (relaxation of the state exemptions but estate inclusion for gifts within three of deaths).

q. **Broad Spectrum of Estate Planning Services Beyond Just Saving Federal Estate Taxes.** Following the passage of ATRA, Lou Mezzullo, President of the American College of Trust and Estate Counsel, sent a letter to ACTEC Fellows reminding them of the many services that professionals provide to clients other than federal transfer tax planning. He provides the following list, not meant to be exhaustive, of some of those items (quoted with his permission).

1. Planning for the disposition of the client's assets at his or her death.

2. Asset protection planning.

3. Planning for disability and incompetency.

4. Business succession planning (without the estate tax to blame for failure of a business).

5. Planning for marital and other dissolutions.

6. Charitable giving (for its own sake, and because income tax considerations will still be relevant and techniques, such as lifetime charitable remainder trusts to facilitate diversification, would not be affected at all).

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

8. Fiduciary litigation (enhanced because more to fight over).

9. Retirement planning.

10. Planning to pay state death taxes (in many states).

11. Planning to avoid or minimize gift taxes (and client desires to gift more than the $5 million indexed applicable exclusion amount for gift tax purposes).

12. Using business entities to accomplish nontax objectives.

13. Planning for children with disabilities.

14. Planning for spendthrift children.

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

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

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

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

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

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

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

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

4. STRUCTURING TRUSTS AND TRUST DESIGN STRATEGIES

At the 2015 Heckerling Institute on Estate Planning, David Handler (Chicago, Illinois) discussed trust provisions that are important for any trust. Even highly sophisticated transfer planning strategies typically involve trusts, and the fundamental trust design issues often get short shrift. The result of the planning, however, is that the assets end up in a trust and the trust document controls the assets for many years. (Mr. Handler's article includes trust provisions for many of the issues summarized below, as well as for many other issues.) In addition, Lauren Wolven (Chicago, Illinois) discussed various interesting issues regarding the need for documents to address specifically provisions for spouses and descendants in light of changing definitions of the "modern family."

a. **Trustee Appointment**. The provisions for appointment of the initial and successor trustees are the most important provisions in the entire document. See Item 4.I of the Summary (December 2014) found here and available at www.Bessemer.com/Advisor for highlights from a recent article about this same topic. Charles A. Redd, *The Most Disrespected Decision in Estate Planning,* TRUSTS AND ESTATES 13-14 (July 2014).

   Successor Trustees. A fixed list of original and successor trustees does not work well; the settlor invariably will want to change that list at some point in the future. Alternatively, provide a list of persons who can appoint trustees, and perhaps the flexibility to add to that list of appointers. The appointers should also have the authority to specify the conditions and terms for who can be appointed as successor trustee (for example, to specify that spouses of children would not be permissible trustees).

   Trustee Removal. The trustee appointers may also be given the authority to remove trustees. If a list of removers is used, it typically includes the grantor, the grantor's spouse, and then descendants if above a certain age. (Under Revenue Ruling 95–58, the grantor can have a trustee removal power as long as the trustee must be replaced by someone who is not related or subordinate to the grantor.)

   Beneficiaries as Trustees. If a beneficiary is a co-trustee, the trust must have an ascertainable standard for distributions in which the beneficiary co-trustee participates. An independent trustee could also have a broader discretionary standard for making distributions to the beneficiary. A beneficiary-trustee who can make distributions to himself only for health, education support and maintenance could be authorized to add an unrelated co-trustee who would have broad authority to make distributions to the beneficiary.

   Adding Co-Trustees. The instrument can provide a procedure for adding co-trustees (by a settlor, beneficiary, trustee, trust protector, or others). The settlor can have the power to add co-trustees as long as the settlor cannot appoint himself or herself. *Durst v. U.S.*, 559 F.2d 910 (3d Cir. 1977) (corporate trustee had a power to control disposition, and grantor reserved right to name an individual trustee as co-trustee; court concluded that grantor could not name himself, and there was no estate inclusion).

   Administrative Trustees. The instrument can authorize the appointment of a co-trustee for certain functions, including as an administrative co-trustee who would have the responsibility of maintaining records of the trust. An administrative trustee in a

particular state may be appointed to facilitate obtaining sufficient nexus with a state to apply that state's governing law.

Investment Trustee. If permissible under state law, a particular co-trustee could be given the responsibility for making investment decisions. The grantor can be the investment trustee. *Old Colony Trust Co. v. U.S.*, 423 F.2d 601, 603 (1st Cir. 1970)(broad trustee administrative powers that could "very substantially shift the economic benefits of the trust" did not invoke section 2036(a)(2) because such powers were exercisable by the donor-trustee in the best interests of the trust and beneficiaries, and were subject to court review). Managing investments is an administrative power that will not cause estate inclusion for the grantor, as long as there is no authority over closely held stock under section 2036(b) or life insurance on the grantor's life (to avoid §2042 inclusion).

b. **Trust Protectors**. A trust protector may be given the authority to take "settlor-type" actions that the settlor cannot retain directly for tax reasons. For example, a trust protector could have the authority to amend the trust to make administrative changes (which could include such things as providing a broker with specific authorization language to implement a certain transaction, to correct scriveners' errors, to make adjustments for tax law changes, or to change the name of the trust). Be wary of authorizing broader trust amendments, for fear the settlor would constantly want to amend the irrevocable trust every time the settlor amends his or her revocable trust or will.

A problem with appointing a trust protector is deciding who should serve in that role. The trustee is the most "trusted" person from the settlor's point of view. Who can override that? The settlor needs "an even smarter and even more trusted person" to override the trust with the trust protector powers.

c. **Powers of Appointment**. The trust might give an individual (usually a family member) a non-fiduciary power of appointment to redirect who will receive assets, to change the division of assets among beneficiaries, to change the trust terms, etc. Many years later the settlor's children may be in a better position than the settlor to decide how the assets should be used for their respective children. "A fool on the spot is worth a genius two generations ago." Also, the power of appointment is a "power of disappointment," giving the powerholder a "stick" over other disgruntled beneficiaries. "I brought you into this world and I can take you out of this trust."

The power of appointment should specify the manner in which it may be exercised (for example, in further trust, the ability to grant further powers of appointment, etc). It should also specify the mechanics of exercising the power (such as whether the last exercise controls and whether an exercise is revocable until it becomes effective).

Contingent Powers of Appointment. There has been an increased interest in the last several years in granting a formula contingent testamentary general power of appointment or giving someone the authority to grant a general power of appointment to a beneficiary (to achieve a basis step-up to the extent possible without increasing estate taxes of the beneficiary and/or to make use of the beneficiary's GST exemption). Observe that achieving a basis step-up is typically not an issue for non GST exempt trusts because a basis step-up is permitted after a taxable termination caused by the death of the beneficiary. §2654(a)(2). One planner's preferred approach is to include

a general power of appointment for beneficiaries but to give the trustee or some other powerholder the authority to remove the general power. Such a provision might also direct that the trustee can exercise its discretion to remove a general power of appointment only if requested to consider exercising that discretion by a beneficiary.

Whether or not having a general power of appointment for a beneficiary is preferable may turn on a variety of facts, such as where the child is domiciled, what are the estate and income tax rates in that state, does the child have excess estate exemption, etc. Those factors can change as exemptions go up or down, as the child moves, or as the child's assets climb or decline in value.

d. **Dividing Trusts**. "Share toys, not money." Big problems erupt if all siblings are beneficiaries of the same trust and share out of the same trust account. "That does not make for good holiday dinners." They will have differing views on management, investments, and distributions. This can arise, for example, if a single trust is created after the first spouse's death for the surviving spouse and all of the decedent's children. The surviving spouse may not need distributions from the trust, and the children in effect have to share the same trust for what could be decades. Authorize the division of a trust into sub-trusts for the separate respective beneficiaries.

e. **Distributions**. Every client asks what "support and maintenance" includes. "Can I buy the fourth house?" Helpful flexibility is added by giving a third-party trustee the authority to make discretionary distributions in the trustee's sole and absolute discretion, without requiring equal distributions, considering or not considering outside financial resources, and to or for the benefit of the beneficiary. All of those could be included with perhaps the additional emphasis "and I really mean it."

Advancements. A trustee may be very reluctant to make a large distribution to an older beneficiary from a trust for multiple beneficiaries. The trustee may be more likely to do so if the trustee has the authority to treat the large distribution as an advancement of that beneficiary's share of the overall trust. Give the trustee the flexibility to treat distributions as advancements without requiring that all distributions be treated as advancements.

Use of Property. The trust may give the trustee the authority to allow a beneficiary to use real property owned by the trust, with or without rent of other charges (but requiring that any trust that qualifies for the marital deduction may not permit anyone other than the settlor's spouse to use trust property for less than fair market value).

Trustee Guidance and Incentive Provisions. Incentive provisions are difficult to draft in a manner that will make sense in the future. A simple incentive trust rule may have many exceptions that swallow the general rule. A preferable approach to using incentive provisions is to give the trustee broad discretionary distribution authority with a statement of guidance and principles. A sample clause (from David Handler) is as follows:

> I request (but do not require) that when determining whether to make a distribution to a descendant of mine from any trust hereunder and the amount of such distribution, the trustee do so in a manner that assists, encourages or rewards such descendant for exhibiting or accomplishing the following "desired behaviors":
>
> (a) pursue an education at least through college and/or a vocational/technical school;
>
> (b) be gainfully employed with a view toward being financially self-sufficient;

(c) be a law-abiding member of society;

(d) be a productive member of society by making meaningful and positive contributions to family, community and society;

(e) engage in entrepreneurial and/or creative activities;

(f) handle money intelligently and avoid wasteful spending;

(g) act with empathy, thoughtfulness, kindness and consideration toward others;

(h) develop healthy and meaningful relationships;

(i) make contributions of time, money or both to charity; and

(j) maintain a healthy lifestyle, both physical and mental.

The trustee should consider the societal norms in the geographical area in which a beneficiary resides, as I do not intend for the trustee to impose his own personal beliefs on a beneficiary as to what constitutes "gainful employment," "healthy lifestyle," or other subjective notions referred to above, although the trustee's beliefs are certain to be a part of such determinations.

Of course, a beneficiary's age, health, abilities and other circumstances will affect his or her ability to accomplish one or more of the desired behaviors, and should be considered in construing and applying the foregoing to any particular beneficiary. I consider full-time parents to be productive members of society and gainfully employed, and do not intend that a beneficiary be discouraged from choosing to raise a family as his or her sole occupation.

I do not expect a beneficiary to necessarily accomplish or exhibit all of the desired behaviors, and recognize that some desired behaviors may even conflict with others. It is my hope and intent that the trust property will be used to reward and enhance the quality of life of those beneficiaries that have exhibited, accomplished or are working toward accomplishing one or more of the desired behaviors, and to encourage and assist the beneficiaries to exhibit and achieve the desired behaviors. On the other hand, I also hope and intend that the trust property will not be distributed to a beneficiary who is engaging in self-destructive, abusive or illegal behaviors ("undesired behaviors"), except for the beneficiary's health, education and basic support, which may include expenses for rehabilitation and treatment or care.

If the trustee, in the trustee's discretion, determines (1) that a beneficiary is not capable of handling money or financial affairs prudently, or (2) that a beneficiary has financial problems or marital difficulties that could result in the diversion or dissipation of trust property or property distributed from the trust, then I recommend (but do not direct) that the trustee refrain from distributing property to the beneficiary until such problems have been resolved to the trustee's satisfaction.

The trustee shall have no duty to inquire or monitor whether a beneficiary is exhibiting or accomplishing the desired behaviors or the undesired behaviors, as the guidelines set forth in this Article are not intended to limit the trustee's discretion to make distributions to the beneficiaries, but the trustee should consider the sentiments expressed in this Article.

(This form, many other forms included in David's materials, as well as a variety of forms and David's detailed excellent estate planning analysis and discussion are in DAVID HANDLER, COMPLETE ESTATE PLANNING SOURCEBOOK (available online at wolterskluwers.com).)

As an example of other forms to assist in providing guidance to trustees regarding distribution decisions, Lauren Wolven offers the following clauses providing detail as to what is meant by "best interests" and "support."

<u>Best Interests</u>. Whenever the Trustee is authorized or directed to pay to, or apply for the benefit of, accumulate, or otherwise administer income or principal for the best interests of a beneficiary herein, the term "best interests" shall be liberally construed by the Trustee and shall contemplate not only authorized distributions for the support of said beneficiary (if such distribution shall be deemed to be in the best interest of said beneficiary by the Trustee) but

also authorized distributions for such beneficiary's comfort, happiness and convenience. By way of illustration and not in limitation thereof, the best interests of a beneficiary may include the right of the Trustee to make distributions as will permit a beneficiary to travel for business, pleasure, or educational purposes; to purchase an automobile; to purchase or furnish a personal residence; to purchase, initiate, or invest in a business interest which the Trustee personally deems to be sound or promising, even though such business might be the type of investment in which, because its risk, the Trustee could not or would not invest for the trust estate; to acquire, receive, or enjoy benefits deemed by the Trustee to be luxuries; to enable such beneficiary to celebrate his or her wedding or other commitment ceremony with a suitable reception in keeping with such beneficiary's style of living, and to enable such beneficiary to augment his or her separate income or estate as such beneficiary sees fit. In addition, if a beneficiary is a minor, the term "best interests" might also include, by way of illustration and not in limitation, the right of the Trustee to provide such sums to enable such beneficiary to attend a summer camp; to take vacation trips; to participate in social activities of interest to such beneficiary and such beneficiary's peers; provided, however, that if any person or persons have the legal obligation to support any such beneficiary, the Trustee shall endeavor to make payments which are not in satisfaction of any obligation of support; provided, further, however, that if the Trustee deems it necessary to provide support for a beneficiary the Trustee shall have full power to do so. In making any such discretionary distribution, the Trustee may consider the ability of said beneficiary to deal with and manage the money or property involved, and shall exercise the discretionary powers herein conferred primarily to benefit said beneficiary rather than the remaindermen. This Section is intended solely as a precatory guide to the Trustee and shall in no way be construed to alter, limit, or enlarge the discretions and powers conferred upon the Trustee by any other provision hereof nor to require the Trustee to make any distribution to any beneficiary.

Support. The "support" of a beneficiary shall include said beneficiary's support and maintenance in reasonable comfort, medical care (including but not limited to dental and psychiatric care) and education (including but not limited to public or private elementary, secondary, college, post-graduate, professional, vocational, language and artistic studies). Distributions for the support of a beneficiary shall be based upon the standard of living to which such beneficiary shall have been accustomed during the five (5) year period immediately preceding any such distribution, *but may be made only if and to the extent that the other income and resources known to the Trustee to be available to said beneficiary for such purpose (including the income and resources of any person who shall be legally obligated to support said beneficiary) are inadequate [optional to have beneficiary's other resources included].*

The author expresses appreciation to Lauren Wolven and to Horwood Marcus & Berk Chartered (Chicago, Illinois) for the use of the Best Interests and Support clauses.

Blended Family Situations; Typically Contentious Items. In a blended family scenario, disputes may arise between the settlor's surviving spouse and children of the settlor by a different marriage. To reduce the chances of litigation, Lauren Wolven suggests that instruments might address how certain typically contentious items will be paid, such as: real estate taxes on any residence owned by the trust; routine maintenance and repairs on the residence; major capital expenditure (such as a new roof) for the residence; medical expenses and health insurance; utilities; insurance of a residence, artwork or other valuables; income taxes on distributions from the trust; vacation travel; caregivers; and automobiles and auto insurance.

f. **Divorce**. The trust may provide that in the event of a divorce from a family member of the settlor, the divorced person and his or family members will be removed as beneficiaries, trustees, and powerholders. (This may be important to avoid being stuck with grantor trust status inadvertently. Under §672(e), a grantor is deemed to hold any power or interest held by someone who was a spouse of the grantor at the time the trust

was created. It is bad enough that the divorced spouse remains as a trust beneficiary; the grantor may also be struck with paying all income taxes on the trust's income.)

The divorce clause may cover details as to when it applies such as whether it is triggered by being legally separated or upon the filing of a divorce petition.

In structuring distribution standards, fiduciary appointments, and powers of appointment, give consideration to how those provisions might impact whether the trust assets are considered as "marital assets" of a beneficiary in the event of the beneficiary's divorce.

g. **Defining Spouse.** The instrument may make clear who is included as a "spouse" for purposes of the instrument, including same-sex marriages (and whether they are recognized if living in a state that does not recognize the marriage even if the spouses were legally married elsewhere), domestic partnerships, or civil unions.

h. **Defining Children and Descendants**. Specify whether children and descendants include the settlor's children and descendants or only include children and descendants of the settlor *and the settlor's spouse*. If split gifts are made using both spouse's exemptions, the consenting spouse may not want all of the settlor's descendants from prior or subsequent marriages to be included as beneficiaries.

Children Born Out of Wedlock. A traditional approach is to treat children born out of wedlock to a female beneficiary as a beneficiary, but to require that children born out of wedlock to a male beneficiary to be acknowledged by the male-beneficiary in order for the out of wedlock child to be recognized as a beneficiary of the trust.

Adopted Children; Assisted Reproductive Technology (ATR). The instrument should address whether adult adoptions are recognized for purposes of the agreement. (The position of the Restatement (Third) of Property: Wills and Other Donative Transfers §14.5 is to treat an adopted child as the child of the adopting person in someone else's testamentary document only if the child was (i) adopted before he or she reached 18, (ii) or the adopting parent functioned as the parent before the child reached 18, or (iii) if the adopting parent was the foster or stepparent of the adopted child.)

The document can also address what descendants by ATR should be included. Lauren Wolven and Horwood Marcus & Berk Chartered (Chicago, Illinois) provide the following very concise ATR provision:

> A child conceived and born using the genetic material of a designated person after the death of such designated person shall be considered the child of such designated person if all of the following conditions are met:
>
> (i) The child is in gestation within two (2) years after the death of such designated person;
>
> (ii) The designated person
>
> A. signed a record evidencing consent to the use of his or her genetic material after the death of such designated person; or
>
> B. at his or her death, was the spouse of the child's surviving parent, which surviving parent caused such child to come into being, and such designated person had not signed a record evidencing lack of consent to use of his or her genetic material by the surviving spouse; ….

i. **Portability**. The default provision in many revocable trusts is to require that the portability election be made following the first spouse's death if there is unused estate exemption. See Item 5.j below.

j. **Change of Situs or Governing Law**. Trust provisions may give the trustee the authority to change the trust situs or governing law, but do not allow such a situs change to shorten or lengthen the rule against perpetuities applicable to the trust. Do not provide that a change of situs will automatically change the governing law; governing law changes should be intentional.

k. **Avoid Foreign Trust Status**. Require that all "substantial decisions" (as defined in Reg. §301.7701-7(d)(1)(ii)) be made by U.S. persons.

l. **Limitations on Non-Family Trustee's Power to Acquire Closely-Held Non-Family Entities in Which Trustee Has an Interest**. Most settlors will not want to permit a trustee who is not a family member to invest trust assets in his family's business unless the beneficiary's family has an interest in the business or consents to the investment.

m. **Waive Prudent Person Rule**. The prudent person rule for trusts may be more restrictive that the settlor wants. The trust may give the trustee the broadest possible investment discretion consistent with his or her fiduciary duties. The trust may permit the trustee, in making investment decisions, to consider the portfolio of "similar" trusts in determining overall asset allocation, risk, and diversification.

n. **Incapacity of Fiduciary.** There should specific procedures included to determine the incapacity of a fiduciary, short of having to a court declaration of incapacity (which would be very difficult for the family). For example, an incapacitated person might be someone who is a minor or under a legal disability, incarcerated, absent with unknown whereabouts for 90 days, or who does not produce a letter from a physician within 90 days of a request that the person is able to manage business affairs.

o. **Merger or Decanting Authority**. The trust may authorize the trustee to merge the trust assets with a trust for the same beneficiaries having substantially similar terms (not permitting merger with a trust that has a longer applicable perpetuities period). Alternatively the trust may have an even broader provision allowing the trustee to distribute assets, in accordance with the distribution standards, to a trust for a beneficiary (*i.e.*, a decanting provision). Even if the state does not have a decanting statute, the trust can spell out the terms of permitted decanting transactions. Such a provision should incorporate safeguards that are included in some of the state statutes; for example, that the decanting cannot be exercised in a way that would disqualify the trust for the marital or charitable deduction, that a decanting power may not be exercised by a beneficiary in a manner that would cause inclusion of the trust assets in the beneficiary's gross estate, and that a decanting power may not be exercised in a manner that causes the trust not to qualify for a "tax benefit" available to the trust. In addition, do not permit accelerating a remainder interest because that may be deemed to constitute a power to add beneficiaries that would inadvertently cause the trust to be a grantor trust.

p. **Conflicts Waiver**. The trust instrument may specifically authorize a trustee to enter into transactions with itself or an affiliate. For example, it may allow the trustee to invest in

its own mutual funds or other proprietary investments that will provide additional investment flexibility for the trust. As another example, this would permit an individual trustee who is with an accounting or investment firm to use the services of those firms. (That is probably why the settlor selected that person as a trustee.)

q. **GST Provisions**. The trust may contain provisions empowering the trustee to administer trusts in a manner that most efficiently utilizes GST exemption that has been allocated to the trust. This may include the power to sever partially exempt trusts, or the power to make distributions entirely from a trust with a lower or higher exclusion ratio to the exclusion of another trust.

r. **Summary of Important Trust Provisions to Look For in Reviewing Trust Documents.** Steve Gorin (St. Louis, Missouri) offers the following list of specific trust provisions to consider in reviewing a client's existing trust documents to discuss whether further planning may be appropriate:

- Insufficient powers of appointment granted to allow the primary beneficiary to reshape the estate plan as needed;
- Insufficient flexibility regarding distributions in light of the need to get income and capital gain taxes to the beneficiary under today's punitively high trust income tax rates relative to the large majority of beneficiaries;
- Trustee succession either does not take into account a variety of contingencies or is not flexible enough to allow the primary beneficiary or trustees to modify succession in situations in which the client would like that flexibility;
- Need to get basis step-up at the beneficiary's death instead of saving estate taxes (for modest estates); and
- Forced outright distributions that ruin asset protection, when trustee provisions and powers of appointment can achieve the same result as forced distributions without compromising asset (including divorce) protection.

5. PORTABILITY

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

Temporary regulations were released on June 15, 2012 (§§ 20.2010-1T, 20.2010-2T, and 20.2010-3T). Those regulations expired within three years (i.e., on June 15, 2015), and the IRS issued final regulations, effective June 12, 2015. The final regulations made relatively few revisions from the temporary regulations. Highlights of some of the more important provisions of the regulations include:

- The portability election is made by the executor's filing a timely and complete Form 706 (if the estate tax return is not timely filed and if the estate is small enough that no return would otherwise be required, Rev. Proc. 2014-18 allowed a relief procedure for certain estates through December 31, 2014, and the IRS in the preamble stated that the IRS is considering whether to make these types of extensions permanent, as discussed below);
- In most cases there will be no need to list values of assets passing to a surviving spouse or charity on the "timely and complete" Form 706 if the estate was not otherwise required to file an estate tax return (but the return must include an estimate of the total value of the gross estate within specified ranges, including assets passing to a spouse or charity);
- The surviving spouse's DSUE amount is not subject to being reduced if Congress later reduces the basic exclusion amount;
- The regulations adopt the "Example 3" approach of the Joint Committee Technical Explanation, negating any "privity" requirement in calculating the DSUE amount (an approach adopted legislatively by ATRA);
- If the decedent made gifts requiring the payment of gift tax, the excess taxable gift over the gift exemption amount (on which gift tax was paid) is not considered in calculating the DSUE amount;
- The surviving spouse can use the DSUE amount any time after the decedent's death, assuming the portability election is eventually made by the executor;
- Any gifts made by the surviving spouse are first covered by the DSUE amount, leaving the spouse's own exclusion amount to cover later transfers;
- DSUE amounts from multiple spouses may be used to the extent that gifts are made to utilize the DSUE amount from a particular spouse before the next spouse dies; and
- If the estate leaves assets to a QDOT, the surviving spouse cannot use the DSUE amount until the QDOT is fully distributed (or terminates at the surviving spouse's death).

The automatic extension of time for certain estates under the filing threshold to make the portability election announced in Rev. Proc. 2014-18 expired on December 31, 2014, but the preamble to the final regulations states that "[t]he Treasury Department and the IRS continue to receive, and are continuing to consider, requests for permanent extensions of this type of relief. However, such relief is not included in the final regulations."

The preamble to the final regulations also clarifies that a complete and properly prepared return that does not compute the DSUE amount because there is no unused exclusion based on the return as filed will be deemed to have satisfied the requirements for making the portability election if subsequent adjustments result in unused exclusion amount, without the need for making a "protective" portability election.

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

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

c. **Portability Decision is Complex.** Because the portability provisions have now been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. From the planner's perspective, this is a more complex decision involving a wide variety of factors that might apply at the first spouse's death (including the surviving spouse's age and life expectancy, whether assets will likely appreciate substantially, whether assets may be sold during the spouse's lifetime, whether assets will be held long-term even after the surviving spouse's death, whether the assets are those kinds that have larger than normal capital gains rates, the states where the beneficiaries live and their estate and income tax rates, whether there will likely be net consumption of the estate, whether it is important to use trusts that allow both the surviving spouse and children to be potential beneficiaries, etc.).

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

d. **Portability Approach Becomes More Predominant**. Unless there are strong reasons to use credit shelter trusts in $10 million estates, an approach of using portability to take advantage of the first spouse's estate exemption will become more prominent. There are some factors favoring the creation of a credit shelter trust at the first spouse's death (discussed below), but unless one of those apply, a fairly good tax plan is in place for couples with estates under $10 million before the client comes to the planner's office—there would likely be no estate tax at either spouse's death (although future appreciation may conceivably result in some estate taxes at the second spouse's death) and there is a basis step-up at both spouses' deaths. Some planners refer to this as the "do no harm" approach.

e. **Planning Is More Difficult for Planners**. Planners must discuss the portability concepts and various factors impacting the decision of whether to rely on portability rather than using credit shelter trusts with clients and document those discussions. While the portability concept is intended to simplify planning, it has not made life simpler from the planner's standpoint.

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

   - Use a credit shelter trust up to the state exclusion amount (if the state has an estate tax and if the state does not recognize portability [Delaware and Hawaii

(and Maryland beginning in 2019) do recognize portability for their state estate taxes]);

- Leave qualified retirement plan and IRA benefits outright to surviving spouses (to take advantage of the longer-term payout opportunities afforded to spouses);
- Trust vs. no trust planning (*i.e.*, are the non-tax advantages of trusts important to the client—but trust planning can be used either with credit shelter trust or with portability and QTIP trusts);
- Blended family concerns—this is one reason to use the credit shelter trust to avoid complexities that might otherwise apply if conditions change such that estate taxes are owing at the surviving spouse's subsequent death (in which event the QTIP trust may end up substantially "underpaying" or "overpaying" the estate taxes and using a credit shelter trust would avoid that complexity);
- If trusts will be used, is it important for both the surviving spouse and descendants to be discretionary beneficiaries after the first spouse's death? (if so, use credit shelter planning unless the clients live in a "self-settled trust state" in which the surviving spouse could create a trust for himself/herself and the descendants without opening the trust to the spouse's creditor's claims—assuming domestic asset protection trusts work);
- Remarriage possibility—a significant possible disadvantage (especially for younger clients) is that the surviving spouse may remarry and the new spouse may die before the surviving spouse, resulting in a loss of the DSUE amount from the first deceased spouse (unless the surviving spouse made a gift utilizing that DSUE amount before the new spouse predeceased the surviving spouse);
- Asset protection significance—assets that are protected from creditor claims under state law (such as retirement accounts, homestead property and life insurance) can be left in those forms to maintain the asset protected status of the assets;
- Basis issues—the second basis step up is a major advantage of the portability approach (but ways of obtaining basis step up even with credit shelter trust planning may be possible); and
- State estate and income tax impact—If there is no state estate tax for the surviving spouse and a high state income tax for the children, portability may be favored; if there is a state estate tax for the surviving spouse and no state income tax for the children, the credit shelter trust may be favored; the results may be different for particular children depending on whether they are living in a high income tax state or not (some children may prefer the CST-at least up to the state exemption amount- and some may prefer portability).

For clients with estates substantially larger than the double the exemption amount, traditional creditor shelter trust planning is still appropriate.

For a more detailed discussion of the advantage and disadvantages of the credit shelter trust approach and the portability approach, as well as a detailed discussion of complexities and inequities that can arise in a blended family situation if a credit shelter trust is not used at her first spouse's death, see Item 5.d-f of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

g. **Revenue Procedure 2001-38.** Some have questioned whether Rev. Proc. 2001-38, 2001-1 CB 1335 precludes the use of QTIP trusts in connection with a portability election if the estate tax return was filed only to elect portability. It provides that the estate may elect a procedure under which the IRS will ignore a QTIP election "where the election was not necessary to reduce the estate tax liability to zero." However, for various reasons Rev. Proc. 2001-38 does not appear to preclude making a QTIP election even though the estate is relying on portability. This issue is on the 2014-2015 Priority Guidance Plan; unfortunately, this guidance was not issued in connection with the portability final regulations. See Item 2 above.

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

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

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

As between those two approaches, the disclaimer approach seems simpler, but the QTIP approach offers more planning flexibilities in many situations.

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

states, disclaimers may not be recognized for fraudulent transfer purposes with respect to the disclaimant's creditors (*e.g.*, FL. STAT. §739.402(d)) and may be treated as disallowed transfers for Medicaid qualification purposes.

QTIPable Trust Approach Additional Flexibilities. Even though the QTIP approach may seem more complicated to clients, in many ways, the QTIPable trust approach affords greater flexibilities. *Fifteen months.*

- *Fifteen months.* The executor has up to 15 months to decide whether to make the QTIP election and over what portion of the trust.
- *Formula election.* The QTIP election could be made by a formula, thus providing a "savings clause" to assure that no estate tax would be paid at the first spouse's death.
- *GST "reverse-QTIP" election*. If the QTIP election is made, the executor could make the "reverse-QTIP" election and allocate the decedent's GST exemption to the trust.
- *State estate tax.* If the state recognizes a "state only QTIP election," having assets in the QTIP trust may make the planning easier to fully utilize the first spouse's exemption amount without paying any state estate taxes at the first spouse's death.
- *Clayton provision.* Any unelected portion could pass to a standard bypass trust under a "Clayton" provision. (Some planners believe that the surviving spouse should not be the executor making the QTIP election if there is a Clayton provision. The IRS might argue that if the spouse makes the election, the spouse makes a gift of some or all of the assets that would have been in the QTIP trust. Panelists take the position that there *should* be no gift tax consequences; this should be no different than other post-death tax elections [such as where to deduct administrative expenses] that have a direct impact on the amount of assets that pass to the credit shelter trust and to the surviving spouse [or QTIP trust]). However, if the surviving spouse is the executor making the Clayton election, uncertainty would exist for years as to whether a gift results and whether that causes §2036 inclusion issues for some portion of the credit shelter trust.) (As an aside, Jeff Pennell thinks the preferable plan is generally to structure the credit shelter so that it has "QTIPable terms"—mandatory income interest for spouse as the exclusive beneficiary. That would, for example, facilitate getting a PTP credit if the surviving spouse were to die shortly after the first spouse to die. Other panelists observe that clients like being able to make transfers to children and the use of the children for income shifting purposes.)
- *Spouse can retain limited power of appointment*. The surviving spouse can have a testamentary limited power of appointment over the assets in the QTIP trust (or the Clayton bypass trust).
- *Delayed QTIP election decision (even for many years)*. A possibility suggested by some planners is the flexibility to delay making the CST/QTIP decision for

many years, even until soon before the surviving spouse dies, if there are no estate tax concerns and the QTIP election would afford a basis step; the QTIP election may be made at any time on the first estate tax return that is filed late, Reg. §20.2056(b)-7(b)(4). If the trust assets have exploded in value and the surviving spouse would have to pay estate tax if the trust assets were included in his or her estate, the QTIP election would not be made at the later time. Portability would not be allowed with this strategy (because the portability election must be made by filing a timely return). This strategy might be used if the surviving spouse does not need the first spouse's exemption to avoid estate taxes at the second spouse's death; making the late QTIP election would allow a basis adjustment for all assets in the QTIP without increasing federal estate taxes.

- *Section 2519 deemed transfer.* Another possible flexibility with a QTIP trust is the ability of the surviving spouse to make a gift or release a small portion of the income interest (say 1%), and be treated as making a gift of the remainder interest under §2519. This may be a way that the surviving spouse could make a taxable gift to make use of the DSUE amount to guard against losing the DSUE amount in the event of a remarriage with the new spouse predeceasing. Because the spouse retains 99% of the income, 99% of the QTIP assets would be included in the estate under §2036, which would mean that the §2519 gift of the remainder interest would be excluded from the adjusted taxable gifts in the estate tax calculation. §2001(b)(last sentence); Reg. §20.2044-1(e), Ex.5. (While the adjustment in the amount of adjusted taxable gifts may roughly offset the §2036 inclusion (without regard to subsequent appreciation), the surviving spouse would be able to add to his or her applicable exclusion amount the DSUE amount that was applied in the gift transaction. Reg. §20.2010-3(b).) The deemed gift would not eliminate the benefit of GST exemption allocated to the trust under a "reverse QTIP election." Reg. §26.2652-1(a)(3). (This approach does not make the most efficient use of the gift exemption because the QTIP trust (that constitutes the deemed gift) is not a grantor trust, but this §2519 approach may be all that the willing spouse is willing to do in terms of making gifts.) Additional steps may be required regarding tax allocation to make sure that the first spouse's family benefits from the first decedent's DSUE amount.

QTIPable Trust With Delayed Power of Withdrawal. If the clients want to have the flexibilities afforded by using a QTIP trust (*i.e.*, to have 15 months to decide what QTIP election to make, to make a formula QTIP election, etc.) but still wants the spouse to have an unlimited withdrawal power, consider creating a standard QTIP trust with a delayed withdrawal power. The trust is a general power of appointment trust qualifying for the marital deduction only if the surviving spouse's power of appointment exists immediately following the decedent's death. Reg. §§20.2056-5(a)(4)("must be exercisable in all events"); 20.2056-5(g)(1). For example, provide that the power of withdrawal arises sometime after the estate tax filing date. Any limitations desired on the amount of the withdrawal right could be added (*e.g.,* up to 20% each year). Prof. Jeffrey Pennell suggests that this perhaps should be the default

approach for QTIP trusts, to be removed if the clients don't want the provision. (Jeff observes that most attorneys trust their own spouses after they are dead but think their clients do not trust their spouses.)

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

Additional Creative Approaches Using Both Disclaimers and QTIP Trusts. For creative ideas of further ways to build in flexibility using both disclaimers and QTIP trusts, see Item 5.i of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

i. **Alternative Ways to Use First Spouse's Estate Exemption.** Even if a credit shelter trust is not created at the first spouse's death, there are several ways to make use of the first decedent's exemption during the surviving spouse's lifetime.

(1) *Gift by Surviving Spouse*. One possibility is for the surviving spouse to make a gift equal to the amount of the DSUE amount received from the first spouse. Under the portability regulations, the first spouse's estate exemption is allocated automatically to cover that gift. The advantage of this approach is that the resulting trust is a grantor trust as to the surviving spouse. The first spouse's GST exemption can still be used if assets are left to QTIP trust with a "reverse QTIP" election and the surviving spouse uses other assets to make the gift to the trust. The disadvantage is that the surviving spouse cannot be a beneficiary of that trust (unless the trust is protected by the spouse's creditors by a DAPT statute).

(2) *Deemed Gift Under §2519*. Another possibility is for the surviving spouse to make a gift of a small portion of the income interest of the QTIP trust, which results in a deemed gift of the remainder interest in the QTIP trust. See the discussion of "Section 2519 deemed transfer" in Item 5.h above.

(3) *Supercharged Credit Shelter Trust℠*. Another possibility is using a "Supercharged Credit Shelter Trust℠." The Supercharged Credit Shelter Trust℠ is a strategy under which a healthy spouse (say W) creates an inter vivos QTIP trust for a spouse expected to predecease (say H). W would have a power to withdraw assets from the trust, but the withdrawal power would lapse at H's death. The gift would be complete at H's death and W would file a gift tax return making the QTIP election. At H's death, the trust assets would remain in a credit shelter trust for W up to the amount of H's estate tax exemption, and the balance would pass to a QTIP trust for W (with H's estate making the QTIP election). Even though W made the original contributions to the trust, §2036 would not apply to the credit shelter trust at W's subsequent death because the QTIP regulations make clear that H is treated as creating the trust for transfer tax purposes, not W, so that §2036 does not apply. Treas. Reg. § 25.2523(f)-1(f) Ex. 11 ("because S is treated as the transferor of the property, the property is not subject to inclusion in D's gross estate under section 2036 or section 2038"). Even though H is treated as creating the continuing trust for W for transfer tax purposes, W is still treated as the grantor of the continuing trust for grantor trust purposes, so the trust is a continuing grantor trust as to W.

See Treas. Reg. §671-2(e)(5). *See generally* M. Gans, J. Blattmachr, & D. Zeydel, *Supercharged Credit Shelter Trust*^{SM}, 21 PROBATE & PROPERTY 52 (July/August 2007).

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

David Handler (Chicago, Illinois) indicates that he typically mandates in wills that the portability election will be made following the first spouse's death. Professor Stanley Johanson (University of Texas School of Law) suggests the following clause:

> If my husband survives me and my husband or his representative requests that my executor make a portability election with respect to all or a portion of my "deceased spousal unused exclusion amount," I direct my executor to make the election in the amount and under the terms provided to my executor by my husband or his representative. The cost of preparing and filing a Form 706 federal estate tax return making the portability election shall be [charged against my estate as an administration expense] [borne and paid for by my husband].

Similarly, consider these issues in pre-marital agreements.

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

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

- The importance of covering the filing/ portability issue in the couple's estate planning documents or marital agreement, including who pays for the cost of filing the return if it will be filed just to make the portability election;
- The possibility of opening a probate estate for the purpose of having an executor who can negotiate for the preparation of an estate tax return;
- Whether the surviving spouse is the appropriate person to serve as executor;
- The value of the right to file the estate tax return and make the portability election and whether the executor should negotiate to receive payment for making the election (a surviving spouse's counter argument is that the spouse may claim the available family allowance or spousal allowance that may be available to the spouse under applicable state law if the portability election is not made; the spousal allowance may be relatively small [e.g., $25,000 in

Indiana] or can be fairly large [e.g., amount needed for the spouse's and minor children's maintenance for one year without regard to other resources available for the spouse's support in Texas, TEX. ESTATES CODE §353.102]); and

- The importance of the surviving spouse disclosing the potential benefits of portability when negotiating a payment for filing the return.

k. **Financial Impact**. Diana Zeydel (Miami, Florida) drew various conclusions from financial modeling (using a "Monte Carlo analysis" to take into consideration the volatility of possible outcomes) of likely outcomes with a diversified portfolio.

- A key element of any planning is to give the clients assurance that sufficient assets will be available for their lifestyle needs for life. Financial modeling can examine the effects of planning strategies if there are "down" markets in the future. Realize that for everyone, cutting back on lifestyle is extremely difficult, whether someone is used to living on $50,000 per year or $2 million per year.
- Surviving spouses typically have an "overlife" of 10 years of more. That is long enough for assets to have substantial appreciation and making the right choice can have a significant financial impact on the family.
- The financial impact to a family of doing planning vs. no planning and the effects among various different strategies is not nearly as dramatic as before ATRA—because of the large indexed exemptions.
- The credit shelter trust vs. portability decision can vary greatly depending on the state estate tax on the spouses and the state income tax that applies to the children. If there is no state estate tax for the surviving spouse and a high state income tax for the children, portability may be favored. If there is a state estate tax for the surviving spouse and no state income tax for the children, the credit shelter trust may be favored.
- For a couple with $10 million that spends 4% annually, leaving assets outright to the surviving spouse or in a QTIP trust and relying on portability will likely result in no estate tax being payable at the surviving spouse's subsequent death (the median result is that the assets will decline to about $9 million). However, there is no certainty of this. In 5% of the cases, the assets could grow to $18-20 million. Using a QTIP trust to make use of the first spouse's GST exemption means that most of the couple's assets would likely end up in GST exempt trusts.
- For a couple with $30 million (or more), the likelihood of achieving significant estate tax savings by using a credit shelter trust rather than relying on portability is very high, even if the spending level is 5%.
- For the couple with $30 million (or more), even greater amounts (and significantly more GST exempt amounts) could be transferred to descendants following the surviving spouse's death by using a "Supercharged Credit Shelter Trust℠" (described in Item 5.i above.) (This is because the credit shelter trust created for the surviving spouse is a grantor trust as to the surviving spouse, meaning that the trust can accumulate assets much more efficiently during the surviving spouse's lifetime and that the income tax payments will reduce the spouse's assets that are subject to estate tax.) For an even better result, the surviving spouse could make a

gift to a grantor trust using his or her own exemption amount as well as taking steps to use the decedent's exemption amount (by a gift of the DSUE amount from the decedent or by using the Supercharged Credit Shelter Trust[SM] approach).

A key result of using these approaches is that substantially more of the wealth passes to descendants in a GST exempt nature. As a practical matter, the portion of the estate that is non-exempt will likely be consumed by the children-generation (as discussed below).

- For clients with a diversified portfolio with typical turnover for a diversified portfolio, whether or not a basis step-up is available at the second spouse's death is not overly significant. (Gains are realized significantly during the surviving spouse's lifetime, and there is not a great deal of unrealized appreciation that would lose the benefit of a basis step-up.)
- The modeling shows that sales to grantor trusts are substantially more effective in transferring wealth than GRATs (as expected).
- For very large estates, doing "garden variety" sales to grantor trust planning can achieve huge transfer tax benefits—and a substantial part of the benefit is that much more of the estate will pass to the family in GST exempt trusts. For example, with a $100 million estate, if the spouses each currently make gifts of their $5.43 gift exemption amounts to GST exempt grantor trusts and annually make gifts of the additional indexed exemption amounts, and if W sells $48.9 million of assets to her grantor trust (9 to 1 debt to equity ratio), with reasonable assumptions on consumption rates, approximately 85-90% of the estate will be in GST exempt trusts at the second spouse's death assuming H dies in 5 years and W dies in 20 years. (Probably all of the estate, even for very large estates would pass for grandchildren in GST exempt trusts because the children will likely consume much if not all of the assets from the non-exempt trusts that are left after the deaths of both spouses. Children will want to live in the same lifestyle as their parents, and if there are multiple children, the assets get divided too much to really permit that—leaving the conclusion that children will likely consume most or all of the non-exempt trusts.)

6. Unwinding Transactions Post-ATRA

The large indexed gift and estate exemptions under ATRA with portability means that most Americans will have no federal gift or estate tax concerns. (Estimates are that less than 0.14% of decedents who die each year will owe federal estate tax). Many clients did planning in prior years to reduce estate taxes when the exemptions were much lower (for example, $600,000 in 1997), and some of that planning is no longer needed, and indeed may be counterproductive. The clients may want to reverse transactions that generated valuation discounts or that removed assets from the client's gross estate so that the full value of those assets will be entitled to a basis adjustment at the client's death. John Bergner (Dallas, Texas) discussed possible strategies at the 2015 Heckerling Institute on Estate Planning.

a. **Avoiding Discounts.** If assets were contributed to or acquired in entities or were held in co-ownership, valuation discounts may apply. For example, if a $1.0 million asset is

discounted by 40%, that $400,000 discount may result in no estate tax savings (if the client does not have an estate large enough to generate estate taxes with the large indexed/portable exemptions), but the $400,000 discount may result in losing a basis step-up of $400,000, which may cost $400,000 x 23.8%, or $95,200 (or more if here are also state income taxes). Indeed, the IRS may argue in income tax audits for high discounts, and taxpayers may argue that the discounts should be lower.

Possible strategies include the following.

Redemption of Partnership or LLC Interest. The redeemed partner generally does not recognize gain except to the extent that any money received exceeds the partner's basis in his partnership interest. (Distributions of marketable securities are treated as distributions of cash unless one of the exceptions to §731(c) applies.) Non-cash assets are received with a basis equal to his basis in the partnership interest. The individual would then own the assets outside the entity and would not be discounted at death. (This may result in giving up centralized management/asset protection features of the partnership or LLC.)

Liquidate Entity With Discountable Interests. As with redemptions, the partners generally recognize gain on their liquidating distributions only to the extent that money received exceeds the basis in their respective partnership interests. A partner's outside basis is reduced by any money received and is next allocated to unrealized receivables and inventory items, and finally to other distributed properties. (The partner's outside basis becomes his substituted basis of the assets received in liquidation.) Other distributed properties that may have a low basis would receive a basis adjustment at the partner's death. (Centralized management/asset protection features of the partnership or LLC would be lost.) **Before liquidating, make sure that no partner has contributed appreciated property within 7 years**; otherwise a partner may recognize gain if property is distributed to someone different than the contributing partner. §§704(c)(1)(B) & 737.

Purchase General Partner Interest. The client might purchase general partnership interests held by others so that the client has control of the entity to minimize discounts.

Convert Limited Partnership to General Partnership. General partnerships typically do not have limitations on the ability to withdraw or force dissolution of the partnership that results in discounts for limited partners. Conversion of a limited partnership to a general partnership should not have income tax consequences.

Amend Entity Documents To Eliminate Features That Cause Discounts. Entity agreements may be amended to remove features that generate discounts, such as removing limitations on the right to withdraw (perhaps allow all limited partners to withdraw for "net asset value" or for "fair value" determined as going concern value without discounts), requiring the distribution of all income, revising how the agreement is amended (permit majority vote to control for amendments and liquidation), or being able to compel a liquidation of his interest based on net asset value. Some degree of transfer restrictions will still be desired in order for the family to have some control over who can become a partner (example, they will not want creditors to be become partners).

Merge Discounted Fractional Interests. Fractional interests in real estate often yield discounts in the 20%-40% range. The client might purchase undivided interests held

by others, so the client would die owing 100% of the property without any discount, or the parties might divide multiple co-owned properties so that the respective parties own 100% of certain properties. If the co-owners are the grantor and his or her grantor trusts, this could be done without realizing taxable gain.

Co-Ownership Agreement. The co-owners might agree to a co-ownership agreement that would remove some of the features that result in a discount, such as allowing co-owners to force a sale of the asset at its undiscounted value.

b. **Cause Inclusion of Assets in Settlor's Estate**.

Exercise Swap Power to Acquire Low Basis Assets Held by Grantor Trust. The grantor may pay cash to the grantor trust to acquire low-basis assets (so that the assets will achieve a basis adjustment at the grantor's death). If the grantor purchases the assets for a note, it is uncertain what basis the trust will have in the note—and whether future payments may generate gain to the trust. If the grantor does not have sufficient cash to make the purchase, the grantor may borrow cash from a third party lender to make the purchase. Consider using a defined value clause in exercising the substitution power to minimize possible gift issues. Advise the client of the possibility of disclosing this "non-gift" transaction on a gift tax return and making adequate disclosure to start the statute of limitations on gift tax assessments. (Interestingly, the adequate disclosure regulations do not require that an appraisal be attached to a return reporting a "non-gift" transaction.)

If No Swap Powers, Negotiate Sale With Trustee. If the grantor does not have a substitution power, the grantor could negotiate to purchase low basis assets from the grantor trust.

Convert to Grantor Trust. If the trust is not a grantor trust, consider taking steps to convert the trust to a grantor trust so that the grantor can acquire the low basis assets from the trust in a non-taxable transaction. Possible strategies include a court modification to include a substitution power of other grantor trust "trigger" power, decanting to a grantor trust, or borrowing from the trust.

Section 2036/2038 Inclusion. The settlor might become the custodian of an UTMA account or the trustee of a trust that does not have determinable standard for distributions. Alternatively, multiple settlors might invoke the reciprocal trust doctrine. Missteps in the correct operation of a transfer planning strategy (which can happen with the best of intentions) may support an argument of an implied agreement of retained enjoyment. This could include such things as continuing to use the trust assets without paying fair market rental value or making installment payments on sales transactions with a grantor trust with entity distributions that match the note payment amounts. However, the intention of the grantor at the time of the original transfer is what is determinative under §2036. If at that time the grantor did not intend to retain use of the asset, subsequent intentional "missteps" should not trigger §2036. *See Estate of Riese v. Commissioner*, T.C. Memo. 2011-60 (lease payments were not made for settlor's continued use of residence after termination of QPRT term within the 6-month period from the termination date to the date of her death; IRS argued that reflected an implied agreement of retained enjoyment; court determined that she had intended to pay rent but the attorneys had merely not determined rental payments and prepared a lease prior to her death and "[t]here was no understanding, express or implied, at the time of transfer that decedent could occupy the residence rent free").

This issue of looking back to intent at the time of the original gift does not apply to §2038 inclusion. Therefore a court modification to add the grantor as a co-trustee (if there is not a "determinable interest" standard on distributions) or to give the grantor a limited power of appointment among the class of beneficiaries would trigger §2038 inclusion.

Beneficiary Argue for Estate Inclusion. If a decedent did not include on the estate tax return an asset that had been transferred, can a beneficiary later make the argument (for income tax purposes) that the decedent should have included that asset on the estate tax return (because he used the asset without paying rent, because there was a sale to a grantor trust in which every dollar of income was used to make note payments, etc.)? Presumably so. The beneficiary certainly can claim that the actual value at the date of death was different than the value reported on the estate tax return (as long as the beneficiary was not the executor that filed the estate tax return). Rev. Rul. 54-97.

Purchase Remainder Interest in GRAT. If a GRAT has substantial value in highly appreciated assets that will ultimately pass to a remainder trust following the GRAT term, the grantor might purchase the remaindermen's interest in the GRAT (if there is not a spendthrift clause prohibiting that sale of the remainder interest). The grantor will own all assets in the trust, so the GRAT will terminate by merger. The GRAT regulations prohibit a "commutation" of the grantor's interest, but this is the opposite of that. The grantor will own the appreciated assets at death to achieve a basis adjustment. For further details, see Item 28.k of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

Move Trust Situs to State Without Domestic Asset Trust Protection. The grantor may have created a trust with the grantor as a discretionary beneficiary that is sitused in a state with a domestic asset protection trust statute (so that the grantor's creditors cannot reach the trust, which likely prevents the grantor from having a retained enjoyment under §2036). Change the situs and applicable governing law so that the trust is no longer protected from the grantor's creditors, which may cause §2036 to apply.

c. **Avoid Funding Bypass Trust**. Countless situations will arise in which a spouse dies with a traditional formula bequest in a will that has not been reviewed in years that creates a bypass trust when the couple has no federal estate tax concerns at the surviving spouse's subsequent death. Creating the bypass trust will create administrative complexity that the surviving spouse wants to avoid and, perhaps more importantly, will eliminate any basis step-up for trust assets at the surviving spouse's death (because he or she would not own the trust assets). Strategies include (i) reading the will closely to see if there are provisions that could justify not funding or immediately terminating the trust (such as a small termination provision, etc), (ii) using a court reformation or modification to authorize not funding the trust, (iii) negotiating a family settlement agreement to avoid funding the trust, or (iv) decanting to a trust with broader provisions that would authorize terminating the trust.

There are significant transfer tax issues that may arise—the children may be deemed to have made a gift to the surviving spouse if they consent to disbanding the credit shelter trust. That gift may be very difficult to value, especially if the surviving spouse

has a lifetime or testamentary limited power of appointment. Furthermore, the assets passing to the spouse at the first spouse's death will not qualify for the marital deduction unless there is a legitimate dispute (because they do not pass from the decedent but rather pass pursuant to the settlement agreement, *see Ahmanson Foundation v. U.S.,* 674 F.2d 761 (9th Cir. 1981)), so the decedent's full exemption will not be available for portability. Also, there would be no use of the first spouse's GST exemption if the assets do not pass to a QTIP trust (for which the "reverse QTIP election" could be made).

If the bypass trust is not funded, there may still be theories on which it would be recognized. *See Estate of Olsen v. Commissioner,* T.C. Memo. 2014-58 (court determined amount that should have been in bypass trust and excluded that amount from surviving spouse's gross estate); *see generally* Mickey Davis, *Funding Unfunded Testamentary Trusts*, 48TH ANNUAL HECKERLING INST. ON EST. PLANNING ch. 8 (2014). See Item 27 of the Heckerling Musings 2014 and Other Current Developments Summary (February 2014) found here and available at www.Bessemer.com/Advisor.

d. **Life Insurance Trust That Is No Longer Needed**. The client may have created a life insurance trust that is no longer needed to avoid paying federal estate taxes. Planning strategies include surrendering the policy if it is no longer needed (which can raise income tax and fiduciary concerns), selling the policy to a third party (which may generate a greater return than surrendering the policy), or having the grantor exercise a swap power to acquire the policy or purchase the policy from the trust for the policy's fair market value.

e. **Turning Off Grantor Trust Status.** The client may want to take steps to "turn off" grantor trust status to avoid paying income taxes on the income of existing trusts if that achieves no estate tax savings. Furthermore, grantor trust status may cause the grantor to dispose of assets to pay the trust's income taxes that if held until death would have received a basis adjustment. However, keeping grantor trust status may be very helpful if the client wishes to substitute illiquid assets into the trust in return for liquid assets for living expenses or to purchase low-basis assets from the trust prior to the grantor's death to achieve a basis step-up at death. If the grantor decides that terminating the grantor trust status is preferable, possible strategies (depending on what causes the trust to be a grantor trust) include (i) releasing a swap power, (ii) releasing a power to add beneficiaries, (iii) changing trustees, (iv) releasing a power to remove and replace trustees if the replacement could be someone who is related or subordinate to the grantor, (v) relinquishing a power to make distributions to the grantor's spouse, (vi) ceasing to pay life insurance premiums (at least not paying premiums with trust income). Once the grantor trust status is terminated, the trustee should consider income tax effects in future distribution decisions; making distributions to low-bracket beneficiaries may reduce the income tax, rather than having all of the trust income (in excess of about $12,300) from being taxed at the trust's top income tax rates.

f. **Causing Inclusion of Assets in a Beneficiary's Estate**. If a trust beneficiary has excess estate exemption, causing assets to be included in the beneficiary's estate, up to the point that no federal estate tax is generated, will allow low basis assets to receive a basis adjustment at the beneficiary's death. For a more detailed discussion of planning strategies, see Item 7.f below.

g. **Causing Inclusion of Assets in a Third Party's Estate.** A beneficiary may exercise a limited power of appointment to appoint trust assets in further trust for a third party (such as a modest-wealth parent or grandparent). The third party would have a testamentary general power of appointment in the new trust (perhaps just exercisable in favor of a creditor of the person and perhaps only with the consent of a third party (someone other than an adverse party)). In default of exercise of the general power of appointment, the assets would return to a trust for the benefit of the beneficiary or someone in the beneficiary's family. The assets would receive a basis adjustment at the third party's death (and the third party's GST exemption could be allocated to the assets).

7. BASIS ADJUSTMENT FLEXIBILITY PLANNING

a. **Consider Importance In Each Particular Situation**. In many situations, clients will have no federal estate tax concerns, and a key tax planning item will be to take advantage of the basis adjustment under §1014 that occurs at the client's death (that generally applies to assets owned by the client at death, but it can apply even more broadly than that.) This can apply to assets that a client owns or to assets in a trust of which a client is a beneficiary. For some clients, this will be a key part of the tax planning to take advantage of what President Obama's tax proposal called "perhaps the largest single loophole in the entire individual income tax code."

In other cases, however, basis adjustments will not be particularly important. For example, if an individual has a diversified managed investment portfolio, traditional turnover in the portfolio will mean that gains realized through the years, and there will not be a great deal of unrealized gain from appreciation in the portfolio. In those cases, basis adjustment planning will not be a priority. The discussion below applies to situations in which basis adjustment planning is determined to be important in a particular client situation.

b. **Consider Using Zeroed Out Transfer Planning.** Consider using transfer planning strategies that minimize the use of the client's gift and estate tax exemption amounts. Leaving estate tax exemption available allows the client to retain appreciated assets until death to receive the benefit of a basis step-up under §1014. For example, consider using GRATs (or "leveraged GRATs") to transfer future appreciation without using any of a client's exemption amount, or making leveraged use of estate and GST exemptions with gifts and much larger sales to grantor trusts.

c. **Consider Using Third Parties' Exemption Amounts for Basis Adjustments.** A client may give/sell assets to a grantor trust for a third party (such as a modest-wealth parent of the client) who will have a testamentary general power of appointment in the trust. At the parent's death, the inclusion of the assets in his or her estate may generate no estate taxes but the assets would receive a basis adjustment (although issues could arise if the parent dies within a year of when the client creates the trust) and the parent could allocate his or her GST exemption to the assets. The assets might pass by default into a trust for the client's benefit but that would not be in the client's estate for estate tax purposes. Melissa Willms (Houston) has referred to the planning as the creation of the "Accidentally Perfect Grantor Trust," with this example:

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

> voting stock to the trust for its current appraised value of $1 million. She uses a combination of seed money and a guarantee by Mary to make sure that the sale is respected for tax purposes. The trust has language that grants Mary a general testamentary power to appoint the trust property to anyone she chooses. Mary signs a new will that leaves the trust property to a dynasty trust for Jenny and her descendants, naming Jenny as the trustee. (Just in case, the IDGT contains the same type of dynasty trust to receive the property if Mary fails to exercise her power of appointment.) When Mary dies four years later, the stock has appreciated to $2 million in value. Because the trust assets are included in Mary's estate, the stock gets a new cost basis of $2 million. The trust assets, when added to Mary's other assets, are well below the estate tax exemption of $5 million. Mary's executor uses some of Mary's $5 million GST exemption to shelter the trust assets from estate tax when Jenny dies. Despite the fact that Jenny has the lifetime use of the trust property, (i) it can't be attached by her creditors, (ii) it can pass to Jenny's children, or whomever Jenny wishes to leave it to, without estate tax, (iii) principal from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants without gift tax, and (iv) if the trust isn't a grantor trust as to Jenny, income from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants, thereby providing the ability to shift the trust's income to taxpayers in low income tax brackets.

Mickey R. Davis and Melissa J. Willms, *Trust and Estate Planning in a High-Exemption World and the 3.8% 'Medicare' Tax: What Estate and Trust Professionals Need to Know*, UNIV. OF TEXAS SCHOOL OF LAW 61ST ANNUAL TAX CONFERENCE (December 2013).

Gift Tax Issues. The trust is a gift by the client, using the client's gift exemption. But the sale to the trust and the payment of income taxes by the grantor may leverage the appreciation of assets in the trust, making use of the client's gift exemption advantageous.

Estate Tax Issues–Parent's Estate. The trust assets contributed to the trust will be included in the parent's gross estate under §2041. The assets that are sold to the trust may also be included in the parent's gross estate, although issues can arise as to whether merely the *net* value of those assets (i.e., net of the debt that the trust owes to the client) is included in the estate. *See Reg.* §20.2053-7 ("if the decedent's estate is not so liable [for the amount of the mortgage or indebtedness], only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need by returned as part of the value of the gross estate"). Having the parent guarantee the trust indebtedness would create a stronger argument for including the full value of the trust assets in the parent's gross estate (to receive a basis adjustment for the assets). The client anticipates that the parent will have plenty of estate exemption so that the parent will pay no estate tax. (If the client thinks that the trust assets may grow to the point that the assets exceeds the parent's estate exemption, the trust could include a formula general power of appointment for the parent, to the extent that inclusion of the trust assets in the parent's estate would not cause the parent's gross estate to exceed the exemption amount. If that is done, the trust would also have to provide that only assets subject to the general power of appointment would remain in trust for the benefit of the client.)

Estate Tax Issues–Client's Estate. The parent will be treated as the transferor of the trust after his or her death, so the client can be the trustee, a discretionary beneficiary (as long as the client cannot make distributions to himself beyond amounts needed for health, education, support and maintenance), and can have a testamentary limited power of appointment over the trust—all without causing inclusion in the client's gross estate—as long as the client's state has passed legislation providing that the client is not treated as the settlor of the trust for creditor purposes (i.e., overriding the traditional "relation back" doctrine—see Item 15.d of the Hot Topics and Current Developments Summary (December 2013) found here and available at

www.Bessemer.com/Advisor for a detailed discussion of the "relation back" issue). A variety of rulings involving "joint spousal trusts" have made this clear. PLRs 200604028, 200403094, 200210051, 200101021. *See* John Bergner, *Waste Not Want Not—Creative Use of General Powers of Appointment to Fund Tax-Advantaged Trusts*, 41st Annual Heckerling Inst. on Est. Pl. ch. 14 (2007).

Income Tax—Grantor Trust. The client will likely create the trust as a grantor trust as to the client. Following the parent's death, there is a strong argument that the trust continues as a grantor trust as to the client under Reg. §1.671-2(e)(5) if the parent does not exercise the general power of appointment. *See generally* M. Gans, J. Blattmachr, & D. Zeydel*, Supercharged Credit Shelter Trust*SM*,* 21 PROBATE & PROPERTY 52, 55 (July/August 2007). If the parent exercises the general power of appointment, the deemed grantor of the trust changes for purposes of the grantor trust rules, and the trust would no longer be a grantor trust as to the client. *See* Mickey Davis, *Basis Adjustment Planning*, 2014 STATE BAR OF TEX. ADV. EST. PL. & PROB. COURSE ch.10 at 21 (2014).

Income Tax—Basis. The assets should receive a basis adjustment at the parent's death because the assets are included in the parent's gross estate (but see the discussion above about the estate tax consequences for the parent as to whether only the net value of trust assets are included in the estate). Mickey Davis points out that if the testamentary general power of appointment is not exercised by the parent, the basis adjustment arises under §1014(b)(9) instead of §1014(b)(4). Section 1014(b)(9) (but none of the other 1014 subsections) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent prior to the decedent's death. Because the "accidentally perfect trust" is usually designed to be a grantor trust, the junior family member is presumably "the taxpayer" for this purpose. The §1014(b)(9) limitation would appear to apply to any depreciation deductions taken by the junior family member prior to the death of the senior family member. As a result, if the trust remains a grantor trust as to the junior family member after the senior family member's death, the amount of the basis adjustment might be reduced by the amount of the depreciation deductions allowed to the junior family member prior to the senior family member's death. See Treas. Reg. § 1.1014-6.

If the parent dies within a year of when the client makes the gift to the trust and if the assets pass back to the client, §1014(e) would prevent a basis adjustment. If the assets merely pass to or remain in a trust of which the client is a discretionary beneficiary (or may be added as a discretionary beneficiary by a third person after some point in time), §1014(e) may not apply, in which event a basis adjustment would be allowed, as discussed in Item 8.c below.

GST Tax Issues. The client could allocate GST exemption to the trust, but alternatively, the client might allocate no GST exemption initially and allow the parent to allocate his or her GST exemption at the parent's death. The parent will be treated as the transferor to the trust for GST tax purposes. §2652(a)(1)(A); Reg. §26.2652-1(a)(1).

Creditor Issues. Under the laws of some states, assets that pass to a trust for the client (either by the exercise of a general power of appointment or upon the unexercised lapse of a general power of appointment) will generally be protected from claims of the client's creditors. *E.g.,* TEX. PROP. CODE §112.035(g)(3)(B) (trust spendthrift

protection applies to irrevocable trust for the benefit of the settlor "to the extent that the property of the trust was subject to a general power of appointment in another person").

Practical Uses. Having a "permanent" $5 million indexed estate tax exclusion amount makes this type of planning realistic; the client can feel very comfortable that the parent will not have estate tax concerns even with the general power of appointment over the trust assets.

Similarly, a beneficiary of a trust who has a limited power of appointment might appoint the assets to a trust in which a third party (such as a modest-wealth parent) has a testamentary general power of appointment. The assets would receive a basis adjustment at the parent's death, hopefully no estate taxes would be payable by the parent, and the parent could allocate his or her GST exemption to the assets. See Item 6.g above.

d. **Preserving Basis Adjustment Upon Death of Donor/Settlor.** For a detailed discussion of basis adjustment planning for donors, see Item 10 of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.Bessemer.com/Advisor. Various strategies for causing inclusion of assets in the settlor's estate to achieve basis adjustments at the settlor's death are summarized in Item 6.b. above.

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

f. **Causing Inclusion of Assets in a Trust Beneficiary's Estate**. If a beneficiary has substantial excess estate exemption, causing inclusion in the beneficiary's estate (up to the beneficiary's excess estate exemption) may afford a basis adjustment at the beneficiary's death without resulting in any federal estate taxes. For example, if a credit shelter trust is used at the first spouse's death and the surviving spouse has excess estate exemption amount, these strategies could be used to cause some or all of the credit shelter trust assets to be in the surviving spouse's gross estate to achieve a basis adjustment at his or her subsequent death. The same strategies could apply to any other beneficiary of a trust who has excess estate exemption. Strategies that may be considered for these purposes are briefly summarized below. Each of these strategies is addressed in considerably more detail Item 7.c-g of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

Distributions to Beneficiary. There are fiduciary concerns as to whether the distribution (especially a large distribution made primarily to achieve a basis adjustment at the beneficiary's death) can be justified within the standard for distributions. If a trustee makes distributions beyond what is authorized in the instrument, the IRS may take the position that it can ignore the distribution. *See Estate of Lillian L. Halpern v. Commissioner*, T.C. Memo. 1995-352.

Exercise of Limited Power of Appointment. Another possible way of addressing the potential reluctance of exercising broad distribution powers because of fiduciary concerns is to grant someone a non-fiduciary power of appointment to appoint trust

assets to the beneficiary. However, gift tax concerns with the exercise of such a power of appointment may arise if the powerholder is a beneficiary of the trust. *See* Treas. Reg. §§25.2514-1(b)(2), 25.2514-3(e) Ex.3; PLRs 9451049, 8535020.

Independent Party With Power to Grant General Power of Appointment. The trust agreement could give an independent party the power to grant a general power of appointment to the beneficiary. It could be a power exercisable only with the consent of a non-adverse party if the settlor wishes to place some controls over the beneficiary's unbridled ability to redirect where the assets will pass. The power could be limited to the ability to appoint the assets to the beneficiary's creditors. Preferably this power would be held by someone other than the trustee. Because of the trustee's fiduciary duty to all beneficiaries, a trustee may be reluctant to grant any particular beneficiary a general power of appointment except in special circumstances (for example if the beneficiary was the only beneficiary and held a broad testamentary limited power of appointment in any event). Perhaps provide that the independent party cannot grant a general power until requested to consider exercising its discretion (to avoid a continuing duty to monitor). One planner's approach is to include a general power for beneficiaries but give the trustee or some other party the power to remove the general power. Query whether a beneficiary may be deemed to have a general power of appointment for tax purposes even before it is actually granted?

Formula General Power of Appointment. To avoid the risk that the third party never "gets around" to granting the general power of appointment, consider granting it by formula in the trust from the outset under a formula approach. The formula could start by giving the beneficiary a general power of appointment up to the amount that would not generate estate taxes in the beneficiary's estate, and could further detail by formula which trust assets would be subject to the general power of appointment.

A very simple formula approach, if the beneficiary clearly does not have to pay estate taxes even considering the trust assets, is to give the beneficiary a testamentary general power of appointment over non-IRD appreciated property. (Only non-IRD appreciated property benefits from a basis adjustment under §1014.) Another very simple formula approach would be to grant the general power of appointment over a fractional share, the numerator of which fraction is "the largest amount which, if added to the beneficiary's taxable estate, will not result in or increase the federal estate tax payable by reason of the beneficiary's death."

Issues may be raised as to whether the limitations under this type of "conditional" general power of appointment would be recognized for tax purposes (so that the beneficiary would not automatically have a general power of appointment over all of the trust assets). However, *Kurz v. Commissioner*, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995) reasoned that if a decedent's general power of appointment was contingent on the occurrence of certain events, the decedent could have some control over the contingency and still not have a general power of appointment, but the contingency must not be "illusory" and must have independent significant non-tax consequences. If the formula grants a general power of appointment up to the amount of the beneficiary's remaining exemption amount less the value of the beneficiary's taxable estate, the beneficiary has a great deal of control to increase the amount subject to the general power of appointment by reducing the size of his taxable estate—for example by consuming assets, by making terrible investment decisions, or

by leaving assets to a spouse or charity—which would increase the amount of the formula general power of appointment. However, those would all seem to be acts of independent significance. The risk of such an argument could be minimized

> by drafting the formula clause granting a general power of appointment based on the surviving spouse's taxable estate, determined without regard to marital or charitable deductible transfers. This approach significantly reduces the likelihood that a court would conclude that the surviving spouse holds a general power of appointment over a greater share of the trust assets than his or her available applicable exclusion amount. If it is known that the surviving spouse will make certain charitable bequests, these can be expressly excluded from the calculation, with the same result.

HOWARD ZARITSKY, PRACTICAL ESTATE PLANNING IN 2011 AND 2012.

The formula could also specify which assets are subject to the general power of appointment (and therefore would be entitled to a basis adjustment at the beneficiary's death). Perhaps a trustee or other third party could have the authority to determine which assets are subject to the general power (but would that be recognized for tax purposes?). Alternatively, the formula could specify objectively which particular assets are subject to the general power of appointment formula amount. The formula might allocate the general power first to the assets that if sold immediately prior the beneficiary's death would generate the greatest aggregate amount of federal and state income tax, or it might be customized to apply first to low-basis assets that are the most likely to be sold after the beneficiary's death. Be wary of using a formula that is so complicated to apply that substantial expense would be incurred in applying the formula. For a discussion of general considerations in crafting a formula general power of appointment, see Leonard & Schingler, *Using a "Formula General Power of Apportionment* [sic] *to Resolve Income Tax Basis "Step-Up" Issues in the Age of Portability and a Request for Clarification Regarding Revenue Procedure 2001-38*, CALIF. TAX LAWYER, at 24-32 (Fall 2014). For a much more detailed discussion of the validity of such formula general powers of appointments, with references to various articles discussing them in detail with sample forms, and for examples of formula general powers of appointment see Item 7.e and Exhibits A and B of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

Delaware Tax Trap. The beneficiary who would like to have the asset included in his gross estate, to achieve a basis step-up at the beneficiary's death, could exercise a limited power of appointment that he has under the trust by appointing the assets to another trust in which some person has a withdrawal right or other presently exercisable general power of appointment. That may trigger §2041(a)(3) to cause the assets to be included in the beneficiary's gross estate. (In addition, the trust assets so appointed would be in the other person's gross estate as well, but that person may have modest wealth so that no estate tax would be owed at that person's death.)

Generally, all that must be done to leave open the flexibility of using the Delaware tax trap is for the trust to give the beneficiary a limited power of appointment that includes the power to grant new presently exercisable powers of appointment (the power to appoint in further trust would generally include this authority) and confirm that the perpetuities savings clause is worded in terms of requiring that the interests of beneficiaries must "vest" within the prescribed perpetuities time frame rather than requiring that they be *distributed* during that time frame. Arizona has changed its state

law (and other states are considering similar changes) so that the Delaware tax trap could be triggered by a beneficiary (to cause the beneficiary to include the assets in his or her estate under §2041) by merely exercising a power of appointment in a manner that gives another person a *nongeneral* power of appointment. For a further discussion of the complexities of the Delaware tax trap, see Item 7.f of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

Asset Protection Impact. Distributing assets to a beneficiary obviously subjects the assets to the creditors of that beneficiary. The law is unclear (and developing) as to whether merely granting a general power of appointment to a beneficiary subjects the assets to the claims of that beneficiary's creditors. (It does under the position of the Restatement (Third) of Property, which position has been adopted in various states, including California, Michigan and New York.) A possible solution is to require the consent of a third person (who would need to be a nonadverse party in order of the power of appointment to cause estate inclusion under §2041).

8. Achieving Basis Adjustment At First Spouse's Death Regardless Which Spouse Dies First Or At The Death of a Relative; Limitations Under Section 1014(e) If Donee Dies Within One Year

a. **Community Property.** Spouses in community property states get a basis step-up on all community property regardless of which spouse dies first. §1014(b)(6). The rationale of the basis step-up for both halves of community property goes back to 1948 when the marital deduction was instituted. The general thinking was that husbands would likely own all of the marital assets and husbands were likely to die first, so a full basis step-up would be available for all marital assets for most couples at the first spouse's death. If only the decedent's one-half of community property received a basis step-up, community property states would be disadvantaged compared to common law states. The rule for community property is now based on outdated assumptions, but it continues.

Any separate property could be converted to community property (through a "transmutation agreement"). *See, e.g.*, TEX. FAM. CODE §4.202; TEX. CONST. Art. XVI, Sec. 4.202. But a question arises as to whether that is a transfer that might trigger §1014(e) if the "recipient" spouse dies within one year.

For couples that do not live in community property states, the spouses might create community property by conveying assets to a "Community Property Trust" under Alaska or Tennessee law. See the discussion in Item 1.l of the ACTEC 2013 Fall Meeting Musings found here and available at www.bessemer.com/advisor. If real estate is involved, contribute the real estate to an LLC and transfer interests in the LLC to the Alaska or Tennessee Community Property Trust. The trustee in Alaska or Tennessee should preferably have possession of trust assets to minimize possible disputes with the IRS over the application of appropriate conflicts of laws principles. Some planners have reported audits of such trusts in which no questions were raised about the community property treatment of the assets.

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

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

Several private letter rulings, and in particular PLR 200101021, provide that giving the first decedent-spouse a general power of appointment over all of the joint trust assets is workable to facilitate funding the credit shelter trust at the first spouse's death. This is not as important now that portability is available to avoid wasting the first decedent-spouse's unused estate exclusion. In PLR 200101021, the joint trust was funded with tenancy by the entireties property. Each spouse could terminate the trust, causing the trust property to be delivered to the grantors as tenants in common. Upon the death of the first grantor, he or she had a testamentary general power of appointment over the entire joint trust. In default of exercise of the power of appointment, a credit shelter trust was to be funded with the trust assets, with the balance of the trust assets passing to the surviving spouse.

The IRS ruled that (1) there was no completed gift on creation of joint trust, (2) all of the trust assets were included in the gross estate of the first decedent-spouse, (3) the assets passing to a credit shelter trust at the first spouse's death were not included in the surviving spouse's estate under §2036, (4) there was a gift from the surviving spouse to the first decedent-spouse immediately before the moment of death, but the gift qualified for the gift tax marital deduction, and (5) there is no basis adjustment for assets passing to the surviving spouse because of §1014(e). (Some commentators have questioned whether the deemed gift and gift tax marital deduction ruling is correct [for example, some question how one can make a gift to a deceased spouse that qualifies for the marital deduction when they are not married after the death], and some planners are uncomfortable using this technique without further clarification. The IRS is not attacking them, however.) These rulings and the reasoning of the IRS

are discussed in great detail in John Bergner, *Waste Not Want Not—Creative Use of General Powers of Appointment to Fund Tax-Advantaged Trusts*, 41st ANNUAL HECKERLING INST. ON EST. PL. ch. 14 (2007) (the marital deduction issue in particular is discussed in ¶1404.5).

c. **Section 1014(e) Limitation if Donee of Gifted Appreciated Assets Dies Within a Year and the Assets Pass Back to the Donor.** Another goal of the joint spousal trust is to achieve the result that applies to community property—to obtain a basis step-up on all assets in the trust, regardless which spouse contributed assets to the trust and regardless which spouse dies first.

Section 1014(e) Statutory Provision. Section 1014(e) provides that the basis of property received from a decedent will be equal to the decedent's basis immediately prior to death, rather than its estate tax value, if the property had been given to the decedent within one year before the date of death and if the property passes back to the original donor (or his or her spouse). In applying §1014(e), though, the devil is in

the details—it is a poorly worded statute with many ambiguities. For an excellent analysis of §1014(e) and planning ramifications, see Jeff Scroggin, *Understanding Section 1014(e) & Tax Basis Planning,* LEIMBERG EST. PL. EMAIL NEWSLETTER #2192 (Feb. 6, 2014). Here is §1014(e) in its entirety (emphasis added):

> (e) Appreciated property acquired by decedent by gift within 1 year of death.
>
> (1) In general. In the case of a decedent dying after December 31, 1981, if--
>
> (A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and
> (B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.
>
> (2) Definitions. For purposes of paragraph (1)—
>
> (A) Appreciated property. The term "appreciated property" means any property if the fair market value of such property on the day it was transferred to the decedent by gift exceeds its adjusted basis.
>
> (B) Treatment of certain property sold by estate. In the case of any appreciated property described in subparagraph (A) of paragraph (1) sold by the estate of the decedent or by a trust of which the decedent was the grantor, rules similar to the rules of paragraph (1) shall apply to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale.

If property is given to an individual in hopes of getting a basis increase at the individual's death, several initial planning steps are in order. (1) Make sure the individual does not have creditors who would take the property. (2) Having a medical directive for that person is better than having a living will, so there is more flexibility for keeping the individual alive past the one year date if the property will return to the original donor. (3) There is no risk of §1014(e) applying if the donor is happy with the asset passing to someone other than the original donor at the individual's death.

Application to Joint Spousal Trust. The IRS ruled in PLR 200101021 that §1014(e) applied to the joint trust that gave the first decedent-spouse a general power of appointment over all of the trust assets. The IRS reasoned that assets are given from the surviving spouse to the decedent-spouse at the instant of the decedent-spouse's death and then returned to the surviving spouse—obviously within one year of the gift—therefore no basis adjustment is permitted under §1014(a). *See also* PLRs 200604028, 200413011, 200403094, 200210051 & TAM 9308002. Some commentators question the IRS's reasoning that the surviving spouse makes a gift at the instant of the first spouse's death as a result of relinquishing control to the decedent-spouse. *E.g.,* John H. Martin, *The Joint Trust: Estate Planning in a New Environment*, 39 REAL PROP. PROB. & TR. J. 275 (2004). Furthermore, §1014(e) arguably does not apply if the assets do not return "to" the donor (*i.e.*, the surviving spouse) but remain in trust for the benefit of the surviving spouse. In any event, the IRS position is clear that a basis adjustment is allowed only for the portion of the joint trust assets attributable to the first decedent-spouse's contributions to the trust.

Refinement: "Joint Exempt Step-Up Trust "("JEST"). This planning strategy, with various adjustments, has been referred to as the "Joint Exempt Step-Up Trust (JEST). *See* Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 1,* 40 EST. PLAN. 3 (Oct. 2013); Alan S.

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

If the approach of using a trust protector to add the donor as a discretionary beneficiary at some later time is used, consider delaying the addition until after the statute of limitations has run on the determination of gain from a sale of the property in question. One approach may be to sell the asset soon after if it is acquired from the decedent (which should generate very little gain) and later repurchase similar (or even identical) assets (there are no wash sale rules for recognition of gain purposes). That would start the 3-year statute of limitations on assessment of additional income tax.

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

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

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

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

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

Mark R. Siegel, I.R.C. Section 1014(e) and Gifted Property Reconveyed in Trust, 27 AKRON L.J. 33, 49 (2012).

This analysis suggests that the extent to which a basis adjustment is denied under §1014(e) may depend on the extent of the original donor's interest in the trust that receives property from the decedent. To the extent that there is a mandatory income or principal interest, the actuarial value of that interest would presumably be subject to §1014(e), but what if there is a Clayton provision converting a mandatory income interest to a discretionary interest to the extent the executor does not make a QTIP election? What about discretionary standards for such discretionary interests; how does a fully discretionary or extremely restrictive standard impact the portion deemed to pass to the individual? What if the individual is the trustee with the discretion to make distributions to him or herself within a standard? Does having a limited power of appointment make a difference (even though the assets cannot be appointed to the individual)?

Application of §1014(e) If Donee-Decedent's Estate Sells the Gift Assets. Further uncertainties arise if the decedent's estate sells the assets received by gift within a year. Section 1014(e)(2)(b) provides that in the case of a sale by the estate, §1014(e) applies only "to the extent the donor … is entitled to the proceeds from such sale." If the assets pass to a trust in which the individual has only an income interest, there would not seem to be any interest in the "proceeds" except to the extent that capital gains are allocated to income under the decedent's will or perhaps to the extent that

the trustee is given the discretion under the instrument or state law to allocate capital gains to income.

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

Application to Non-Spousal Transfers. The planning ideas discussed above also apply to gifts to donees other than spouses. In light of the indexed large estate exemption, most decedents will pay not estate tax. Gifts to a donee will receive a basis adjustment at the donee's death without causing any estate taxes to be paid (assuming the exemption covers all of that decedent's assets) unless the donee dies within a year and leaves the asset back to the donor. Even if the donee dies within a year, leaving the assets to a trust of which the donor may eventually become a beneficiary or in which the donor is only a discretionary beneficiary may still receive a basis adjustment at the donee's death.

d. **Section 2038 Marital Trust.** Another possible strategy to achieve a basis step-up for all marital assets at the death of the first spouse is a "Section 2038 Marital Trust." As an example, H creates an irrevocable trust for W as a discretionary beneficiary (H could be the trustee) providing that on W's death the assets pass to her estate. H retains the power to terminate the trust prior to W's death; if the trust is terminated, the assets would be distributed to W. The gift is complete when the trust is created (unlike the joint revocable trust) but the gift qualifies for the gift tax marital deduction (even though the trust is not a QTIP trust) because W is the only beneficiary so her interest is not a "nondeductible terminable interest," Reg. §25.2523(b)-1(a)(2). If W dies first, the assets are in her estate under §2031 and if H dies first the assets are in his estate under §2038. For a more complete discussion, see Item 8.e of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

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

9. IRS's Radar Screen

John Porter (an attorney in Houston, Texas) has summarized discussed trends of issues that taxpayers are seeing in IRS examinations and in court proceedings.

a. **Kitchen Sink Approach.** There is a growing trend of the IRS to add every conceivable argument in the Notice of Deficiency—even though the arguments may not have been addressed in the course of the examination.

b. **Installment Sales to Grantor Trusts**. The IRS is closely examining sale to grantor trust transactions, from both a gift and estate tax standpoint.

c. **Family Limited Partnerships and LLCs.** The most litigated issue is whether assets contributed to an FLP/LLC should be included in the estate under §2036 (without a discount regarding restrictions applicable to the limited partnership interest).

d. **Formula Transfers With Defined Value Clauses.** There are five basic types of these clauses:

- Formula allocation clause, allocating portions of a transferred asset between taxable and non-taxable transfers based on the subsequent agreement of the parties (*McCord, Hendrix*)
- Formula allocation clause, allocating portions of a transferred asset between taxable and non-taxable transfers based on values as finally determined for federal gift tax purposes (*Christiansen, Petter*)
- Clause defining the amount transferred based on values as finally determined for federal gift tax purposes (*Wandry*)
- Price adjustment clause (*King;* but *McLendon* and *Harwood* did not recognize price adjustment clauses)
- Reversions to donor of excess over a specified value (*Procter*)—this condition subsequent approach does NOT work. The clause in *Procter* provided that any amount transferred that was deemed to be subject to a gift tax was returned to the donor. It trifles with the judicial system, because any attempt to challenge the gift or raise gift tax defeats the gift. The *Procter* doctrine does not invalidate all formula transfers. Since the 1944 *Procter* case, many other types of formula clauses have been blessed by the IRS and the courts (marital deduction clauses, GST formula allocations, split interest charitable trust clauses, GRATs, formula disclaimers, etc.).

The 2015-2016 Priority Guidance Plan (sometimes referred to as the IRS's "Business Plan") adds the following item: "Guidance on the gift tax effect of defined value formula clauses under §2612 and 2511." See Item 2.a. above. Apparently, the IRS is adding a regulations project to address defined value formula clauses.

e. **Challenges of Promissory Notes.** The IRS challenges the value of promissory notes, either arguing that the AFR is not a sufficient interest rate, or that the collateral is not sufficient and there are collectability problems. Another argument made in some

audits is that the note transaction is not a bona fide loan but is a gift. The IRS sometimes challenges note refinancings (to lower interest rates).

The 2015-2016 Priority Guidance Plan (sometimes referred to as the IRS's "Business Plan") adds the following item: "Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872." See Item 2.a. above. Presumably the focus of the new regulations will be to address the valuation impact of using the AFR as the interest rate.

f. **GRATs.** There is significant audit activity of GRATs, typically to confirm that the terms of the GRAT are being satisfied, that the annuity payments are being made properly and timely, that all of the requirements of the GRAT regulations are included in the instrument. If there have been substitution transactions with the GRAT, the examining agent closely reviews the values of property involved in the exchange. If hard-to-value assets have been used to make annuity payments, the IRS reviews that proper valuations have been used.