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Heckerling Musings 2018 and Estate Planning Current Developments

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This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients.

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Introduction

The 52nd Annual Philip E. Heckerling Institute on Estate Planning was held in Orlando during the week of January 22, 2018. This summary includes observations from that seminar, as well as other observations about various current developments and interesting estate planning issues. My goal is not to provide a general summary of the presentations. Rather, this is a summary of observations of selected items during the week as well as a discussion of other items. I sometimes identify speakers, but often do not (some topics are discussed by various speakers). I take no credit for any of the outstanding ideas discussed at the Institute — I am instead relaying the ideas of others that were discussed during the week.

1. Summary of Top Developments in 2017

Ron Aucutt (Washington D.C.), provides the following as his “top ten” list of the major developments in the estate planning world in 2017:

- (1) The 2017 Tax Act (see Item 2 below);
- (2) Regulatory environment in the Trump administration (see Item 4.a below);
- (3) An extreme family limited partnership case (the *Powell* case, see Item 15.g below);
- (4) Withdrawal of the proposed regulations under §2704 (see Item 6.e below);
- (5) Continued tension between Congress and the IRS;
- (6) Developments with portability on several fronts (including Rev. Proc. 2017-34, and the *Sower* and *Vose* cases; see Item 14 below);
- (7) Growing legislative acceptance of asset protection trusts;
- (8) Measured retroactive relief for same-sex married couples (Notice 2017-15; see Item 4.f below);
- (9) Decline of state estate taxation; and
- (10) Challenges to the substantiation of charitable contributions, including conservation easements (see Item 9.d below).

Aucutt, *Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2017*, McGuireWoods Website (posted January 11, 2018).

2. 2017 Tax Act and Tax Reform

- a. **Estate Tax Repeal History-1986 Tax Reform Act; Proposals for 2017.** Estate tax repeal has been considered by various administrations. One staffer from 1986 has stated that negotiation of the momentous 1986 Tax Reform Act came down to one last item. The legislative staffers told President Reagan that he could get rid of the estate tax, but he would have to give up the B-2 bomber. President Reagan replied that he would rather keep the B-2 bomber.

The House Republican Blueprint for Tax Reform published June 24, 2016 included a proposal to repeal the estate and GST tax (but presumably to retain the gift tax). President Trump's campaign proposal was to "repeal the death tax, but capital gains held until death and valued over \$10 million [presumably that is per couple] will be subject to tax to exempt small businesses and family farms." The 2017 Tax Act, as described below, does not repeal the estate and GST tax but roughly doubles the estate and gift tax exclusion amount for 2018-2025.

- b. **Legislative Process for Tax Reform Using Reconciliation.** The process for getting tax reform legislation in 2017 was using the budget reconciliation act. The Congressional Budget Act of 1974 (Titles I – IX of the Congressional Budget and Impoundment Control Act of 1974) modified and clarified the role of Congress in the federal budgetary process. It governs the process of annual budget resolutions and budget reconciliations. Title II created the Congressional Budget Office (CBO) to give Congress independent economic analysis; previously the Executive Branch controlled budgetary information. Standing budget committees in the House and Senate were created and additional staffing was authorized for committees involved with budget decisions.

(1) **Budget Resolution.** Title III specifies procedures for the adoption of an annual budget resolution, which is a concurrent resolution that is not signed by the President, that sets out fiscal policy guidelines for Congress (but Congress does not adopt a budget resolution in all years, for example it did not do so last year). (The budget resolution cannot be filibustered in the Senate.) The budget resolution does not enact spending or tax law, but sets targets of overall receipts and expenditures, based on CBO estimates, for other committees that can propose legislation changing spending or taxes. The limits on revenue and spending that it establishes may be enforced in Congress under "points of order" procedural objections (which requires 60 votes in the Senate to waive). Budget resolutions set spending and revenue levels for a budget window (at least five years but typically 10 years). The budget resolution typically is rather straightforward, primarily stating how much should be spent in each of 19 broad spending categories, and specifying how much total revenue the government will collect for each year in the budget window.

The House passed its budget resolution on October 5, 2017 on a mostly party-line vote. The House budget included \$203 billion in mandatory spending cuts and tax changes that do not add to the national debt, but the Senate budget included much fewer mandatory spending cuts and authorized a \$1.5 trillion reduction of federal revenues over the ten-year budget window. Senator Corker emphasized that the \$1.5 trillion deficit agreement was merely to get a budget resolution passed, and that he would still want revenue neutrality over the budget window after applying a reasonable "dynamic scoring" approach before he would vote in favor of the tax legislation in a reconciliation act. See Erik Wasson, *GOP Budget Kicks Off Effort on Tax Cuts. Now Comes the Hard Part*, DAILY TAX REPORT (October 5, 2017). However, he subsequently agreed with the tax reform package, discussed below, despite the revenue impacts.

(2) **Reconciliation Act.** The budget resolution can specify that a budget reconciliation bill will be considered to “reconcile” the work by various committees working on budget issues and to enforce budget resolution targets. Like the budget resolution, it cannot be filibustered in the Senate and only requires a majority vote. The reconciliation directive directs committees to produce legislation by a certain date that meets specified spending or tax targets. The various bills are packaged into a single bill (only one reconciliation act is allowed in each Congressional session) with very limited opportunity for amendment. The reconciliation bill, when ultimately approved by the House and Senate, goes to the President for approval or veto.

The reconciliation process has proved instrumental in being able to pass measures connected with the budget process without the necessity of garnering 60 votes in the Senate. For example, reconciliation was instrumental in the passage of the 2001 and 2003 tax cuts, healthcare reform in 2010, and welfare reform in 1996. Tax reform will not necessarily have to be subject to a 10-year sunset provision (what some planners refer to as a “sunrise” provision) if 60 votes cannot be secured in the Senate if the overall package does not add to the deficit outside the budget window of the act. Some significant tax acts have been passed under the reconciliation process without the sunset provision by finding other “pay-fors” so that net tax revenue decreases do not exceed net outlay decreases outside the budget window. (That was accomplished with the 1997 tax act, but that was in a time of budget surpluses.)

(3) **Byrd Rule.** While the reconciliation act is not subject to Senate filibuster, under the “Byrd rule” (added permanently as §313 of the Congressional Budget Act in 1990) any single Senator can call a point of order against any provision or amendment that is “extraneous” to the reconciliation process for various prescribed reasons—one of which is an entitlement increase or tax cut that will cost money beyond the budget window of the reconciliation bill (typically ten years) unless other provisions in the bill fully offset these costs. (The actual language of the Congressional Budget Act is cumbersome, stating that:

a provision shall be considered to be extraneous if it increases, or would increase, net outlays, or if it decreases, or would decrease, revenues during a fiscal year after the fiscal years covered by such reconciliation bill or reconciliation resolution, and such increases or decreases are greater than outlay reductions or revenue increases resulting from other provisions in such title in such year. 2 U.S. CODE §644(b)(1)(E).)

The offending provision is automatically stripped from the bill unless at least 60 Senators waive the rule. (In congressional vernacular, reviewing a reconciliation act to determine if any extraneous provisions exist is referred to as giving the proposed legislation a “Byrd bath,” and any items that are dropped to avoid having extraneous provisions are called “Byrd droppings.”) The Senate parliamentarian makes the decision as to what provisions violate the Byrd rule. The Vice President, as the presiding officer of the Senate, can override the parliamentarian’s decision, but “the long-standing Senate precedent is to defer to the parliamentarian’s rulings.” Steven Dennis & Laura Litvan, *Senate GOP to Snub House Obamacare Repeal Fill, Write Its Own*, BNA DAILY TAX REPORT (May 5, 2017). (For example, Democrats believed the provision in the House bill to repeal and replace the Affordable Care Act that let states apply for waivers to allow insurers to charge higher premiums to people with

pre-existing conditions if they haven't maintained continuous coverage, provided the state also has a high-risk pool, violated the Byrd rule and could not have been included in the Senate version of the health care reconciliation act without 60 votes. *Id.*)

If the legislation does not result in revenue neutrality after the budget window, the classic approach is to sunset the offending measures at the end of the budget window (which is why the "Bush tax cuts" in 2001 only lasted for ten years), thus resulting in a tax reform measure or tax cuts that would not violate the Byrd rule and that could be passed with a mere majority in the Senate.

The 2017 Tax Act (discussed below) generally sunsets most of the individual and transfer tax provisions (not including, among other things, the chained CPI approach for indexing) after 2025 to avoid having a 60-vote requirement in the Senate under the Byrd Rule.

c. **Overview of 2017 Tax Act.**

(1) **Passage of "Tax Cuts and Jobs Act" (or Reconciliation Act of 2017 or 2017 Tax Act).** The Tax Cuts and Jobs Act passed the House on December 19, 2017 by a vote of 227-203 (with no Democratic votes and with 13 Republican members from California, North Carolina, New Jersey, and New York voting no). The Senate parliamentarian ruled that three provisions in the version passed by the House were "extraneous" to reconciliation (one of which was removing the short title, discussed in the following paragraph) and were removed in the bill that passed the Senate very early in the morning of December 20 by a straight party-line vote of 51-48 (Senator McCain was absent), forcing a House revote of the version passed by the Senate later that same morning. The President signed Public Law No. 115-97 (the "Act") on December 22, 2017.

The short title "Tax Cuts and Jobs Act" was removed, but the Act may continue informally to be referred to by that former and commonly used name. The Treasury and IRS continue to refer to the Act by that name. For example, an IRS website ("Resources for Tax Law Changes" at <https://www.irs.gov/newsroom/resources-for-tax-law-changes>) that contains links to its announcements about the Act refers to "tax changes approved by Congress in the Tax Cuts and Jobs Act (TCJA)." The staff of the Joint Committee on Taxation also refer to the Act by that same name. See Staff of Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2018* (February 7, 2018). The official title is "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." Perhaps the Act will be known as the Reconciliation Act of 2017 or simply as the 2017 Tax Act. Apparently, the Treasury and IRS will refer to it as TCJA.

(2) **Effective Date.** Most of the provisions are effective for taxable years beginning after 2017. Most of the provisions regarding individual tax reform (including the transfer tax provisions) are effective for taxable years from 2018-2025 (i.e., for 8 years). They sunset after that date in order to satisfy the "Byrd rule" so that the Act could be passed with just a majority vote in the Senate under the reconciliation process. The change to the "Chained CPI" indexing approach remains permanent, and generally the business tax reform measures are permanent.

(3) **Simplification.** One of the stated purposes of tax reform was simplification, but many of the provisions add significant complexity. In particular, the various limitations and restrictions on the 20% deduction for pass-through entity qualified business income are very complicated.

(4) **Revenue Impact.** The budget resolution that initiated the reconciliation process for approving the Act (with only a majority vote requirement in the Senate) authorized tax reform that would produce no more than \$1.5 trillion of deficits over the 10-year budget window authorized in the budget resolution. The Joint Committee on Taxation scored the bill as producing \$1.456 trillion of deficits over the 10-year period. It did not provide a “dynamic scoring” estimate taking into consideration economic gains that would result from the Act. The Tax Foundation (a “right-leaning” organization) estimates that the Act would add \$1.47 trillion to the deficit over 10 years, but \$448 billion after considering economic growth. The individual tax provisions of the Act generally sunset after 8 years; the Tax Foundation estimates that making all of the bill’s tax cuts permanent would have resulted in a deficit of \$2.7 trillion over 10 years, or \$1.4 trillion considering economic growth. Accordingly, the sunset provision saves \$1.23 trillion (\$2.7 - \$1.47 trillion) with a static projection, or \$950 billion (\$1.4 - \$0.448 trillion) considering economic gains, and the trend of increasing deficits would have continued to expand in the following decade. Tax Foundation, *Preliminary Details and Analysis of the Tax Cuts and Jobs Act* (Dec. 2017). These estimates of the impact of the sunset provisions suggest that if Congress removes the sunset provisions before 2026, that could raise significant additional deficit concerns, such as increasing the cost of the Act **over just the following two years by almost \$1 trillion** (even considering economic growth), let alone going forward permanently. Accordingly, planning will need to take into consideration the significant possibility that the sunset of the individual provisions (including the transfer tax provisions) will occur.

d. **Transfer Tax Issues.**

(1) **Basic Exclusion Amount Doubled; Other Indexed Amounts.** The Act increases the basic exclusion amount provided in §2010(c)(3) from \$5 million to \$10 million (indexed for inflation occurring after 2011) for “estates of decedents dying, generation-skipping transfers, and gifts made” after 2017 and before 2026. The indexed amount for 2018 using the new “chained CPI” approach has not yet been officially confirmed. The IRS has confirmed that inflation adjusted amounts will be recalculated as a result of the 2017 Tax Act. *See Inflation Figures Being Recalculated, Treasury Official Confirms*, TAX NOTES TODAY (Jan. 29, 2018). Expectations are that the basic exclusion amount for 2018 will be \$11.18 million and the other previously announced indexed amounts for 2018 will remain the same under the chained CPI approach: annual gift tax exclusion – \$15,000; annual gift tax exclusion for non-citizen spouses – \$152,000; limitation on special use valuations – \$1,140,000; and “2% portion” under §6166 – \$1,520,000. *See Staff of Joint Committee on Taxation, Overview of the Federal Tax System as in Effect for 2018* (February 7, 2018) (based on “Joint Committee staff calculation;” describing indexed amount as \$4,417,800 unified credit amount and \$11.18 million exclusion amount); Daniel Evans, *Summary of the Reconciliation Act of 2017*, (Dec. 25, 2017); <http://resources.evans-legal.com/?p=5316>.

The legislative history for the Act (the Joint Explanatory Statement of the Committee of Conference, referred to in this summary as the “Joint Explanatory Statement”) refers to this change as doubling the “estate and gift tax exemption,” but it also doubles the GST exemption because §2631(c) states that the GST exemption is “equal to the basic exclusion amount under section 2010(c).”

The sunseting of the doubled basic exclusion amount raises the prospect of exclusions decreasing, and taxpayers being motivated to make transfers to take advantage of the larger exclusion amount, as in late 2012, but only significantly wealthy individuals are likely to be concerned with the gift tax exclusion amount decreasing to \$5 million (indexed).

(2) **Regulations Will Address “Clawback.”** The Act amends §2001(g) to add a new §2001(g)(2) directing the Treasury to prescribe regulations as may be necessary or appropriate to address any difference in the basic exclusion amount at the time of a gift and at the time of death. This is to deal with the possibility of a “clawback” – i.e., a prior gift that was covered by the gift tax exclusion at the time of the gift might result in estate tax if the estate tax basic exclusion amount has decreased by the time of donor’s death, thus resulting in a “clawback” of the gift for *estate* tax purposes. This is the same issue that was a concern in 2012 when the possibility existed of the gift tax exclusion amount being reduced from \$5 million (indexed) to \$1 million. Most commentators thought there was unlikely to be a “clawback” in that situation; indeed, Congressional staffers had indicated in 2012 that clawback was not intended.

Unfortunately the calculation procedure described in the Instructions to the Form 706 would have resulted in a “clawback.” (Section 2001(g) was added in 2010 to clarify that in making the second calculation under §2001(b)(2)), the tax **RATES** in effect at the date of death (rather than the rates at the time of each gift) are used to compute the gift tax imposed and the gift unified credit allowed in each year, but §2001(g) does not specify whether to use the exclusion amount at the date of the gift or at the date of death for multiplying by the date of death rate to determine the gift credit amount in making the second calculation.)

The estate tax calculation method under § 2001(b) is as follows:

- Step 1: calculate a tentative tax on the combined amount of (A) the taxable estate, and (B) the amount of adjusted taxable gifts (i.e., taxable gifts made after 1976 other than gifts that have been brought back into the gross estate — just the tax using the rate schedule is calculated, without subtracting any credits). I.R.C. §2001(b)(1).
- Step 2: subtract the amount of gift tax that would have been payable with respect to gifts after 1976 if the rate schedule in effect at the decedent’s death had been applicable at the time of the gifts, I.R.C. § 2001(b)(2). The statute does not say whether to use the gift credit amount that applied at the time of the gift or at the time of death — and this is what leads to the uncertainty. Form 706 instructions for the “Line 7 Worksheet” specifically state that the basic exclusion amount *available in each year using a Table of Basic Exclusion Amounts provided for each year from 1977 to 2017* (plus any applicable DSUE amount) that gifts were made

is used in calculating the gift tax that would have been payable in that year. The effect of this calculation is that the tentative tax on the current estate plus adjusted taxable gifts would not be reduced by any gift tax payable on those gifts if the gifts were covered by the applicable exclusion amount during the years that gifts were made. In effect, the tentative estate tax would include a tax on the prior gifts.

- Step 3: Subtract the estate tax applicable credit amount.

The apparent intent of the Act is that regulations would clarify that clawback would *not apply* if the estate exclusion amount is smaller than an exclusion amount that applied to prior gifts.

Presumably, the regulations would also address a potential “reverse clawback problem” that could arise when exemption amounts are increasing. Assume a donor makes a \$2 million gift in a year in which the gift exemption amount is only \$1 million, but the estate tax exemption amount later increases to \$5 million. In making the estate tax calculation, if the hypothetical gift tax payable on the \$1 million gift is merely based on the exemption amount in the year of death, there would be no hypothetical gift tax on the \$2 million gift, so there would be estate tax imposed on the full estate plus adjusted taxable gifts, without any credit for the gift tax *that was actually paid* on the \$2 million gift. One possible approach to avoid that potential problem would be the legislative “fix” that was proposed in the Sensible Estate Tax Act of 2011 (H.R. 3467, §2(c)), which would have calculated the hypothetical gift tax payable on the adjusted taxable gift (which is subtracted in determining the estate tax) using the gift credit amount that applied in the year of the gift, *but not exceeding* the estate tax applicable credit amount in the year of death. Therefore, the higher exemption amount would not be used in calculating the hypothetical gift tax payable.

A more detailed statutory provision that addressed the clawback issue in a different manner was in the 2012 Middle Class Tax Cut Act (S. 3393, §201(b)(2)).

For a further discussion of the clawback issue, see James G. Blase, “Clawback Under New Tax Law” *Trusts & Estates* (Dec. 27, 2017); <http://www.wealthmanagement.com/estate-planning/clawback-under-new-tax-law>.

(3) **Related Clawback Issue – Portability Impact.** If the first spouse dies when the estate exclusion amount is about \$11 million, and calculates the DSUE based on that larger exclusion amount, if the surviving spouse dies after the exclusion amount has reverted back to \$5 million (indexed), will the DSUE from the first spouse remain at the higher level, or is it limited to the exclusion amount in existence at the second spouse’s death? The existing portability regulations provide that the DSUE based on the exclusion amount in effect at the first spouse’s death continues to apply. Regulation Section 20.2010(2)(c)(1) defines the DSUE amount as consisting of the lesser of two elements, and one of those elements is “the basic exclusion amount in effect in the year of death of the decedent.” The regulations in this context are discussing the decedent and the surviving spouse, so the regulation is referring to the basic exclusion amount of the first spouse to die.

(4) **No Estate Tax Repeal.** The House version of the Act would have repealed the application of the estate tax to decedents dying after 2024 (but would have left in place references to chapter 11 in §1014(b) for basis adjustment purposes at a decedent's death). The House version would have left the gift tax in place, but with a reduction in the rate to 35% after 2024.

e. **Individual Income Tax Issues.**

(1) **Rate Brackets.** The Act preserves seven tax brackets, with a top rate of 37% for income starting at \$500,000 (indexed) for single individuals and heads of households and at \$600,000 (indexed) for married individuals filing joint returns. (The applicable income levels for the top rate bracket results a "marriage penalty" of about \$8,000 for taxpayers in the top bracket.) The brackets are revised significantly. As an example, a married couple filing jointly with taxable income of \$700,000 would pay \$222,431 under pre-Act law and would pay \$198,379 under the Act (ignoring any applicable credits).

The top rate for trusts and estates applies to taxable income in excess of \$12,500 (indexed). (Under pre-Act law, the top rate bracket for trusts and estates would have applied to taxable income in excess of \$12,700 in 2018.)

(2) **Indexing Using "Chained CPI."** A different measure of inflation will be used for indexing. The "chained CPI" approach would put more taxpayers in higher brackets over time than under the current indexing approach (and it continues to apply even after the tax changes for individuals sunset after 2025). The chained CPI approach uses the Department of Labor Chained Consumer Price Index for All Urban Consumers ("C-CPI-U") rather than the "CPI-U" index that is used under pre-Act law. Values that are reset for 2018 are indexed with the chained CPI index in taxable years beginning after 2018. Unlike most of the other provisions applicable to individual taxpayers, changing to the chained CPI indexing approach does not sunset after 2025.

The IRS is expected to publish revised inflation adjustments for 2018 using the chained CPI index sometime in January or February, 2018.

(3) **Standard Deduction and Personal Exemption.** The standard deduction is increased to a deduction of \$24,000 for married individuals, and the personal exemption is eliminated. The net result of these two changes will produce a modest tax savings for some (but not all) taxpayers. Under pre-Act law, in 2018 the standard deduction for married couples would have been \$13,000 and the personal exemption would have been \$4,150 so the combined standard deduction and personal exemptions for a married couple would have been \$13,000 + 4,150 + 4,150, or \$21,300 for a couple without children, or \$25,450 for a couple with one child.

Because of the increased standard deduction and the fact that many deductions for individuals are eliminated or limited (as discussed below), the percentage of taxpayers that will itemize is expected to decline from about 30% to about 5%. As a result, many taxpayers will not realize any income tax benefits from charitable contributions, home mortgage interest payments, state and local tax payments, or other payments still qualifying as deductions to those who itemize deductions. Very

importantly for business owners, as discussed above, the 20% deduction for qualified business income is allowed in addition to the standard deduction.

Taxpayers may consider “bunching” deductions into a particular year. For example, a taxpayer might make large charitable contributions in a single year to a donor advised fund, which can be implemented with very little expense or administrative inconvenience by creating an account with an established donor advised fund at a financial institution, community foundation, or other institutional sponsor. The account could be used to fund annual charitable contributions that the taxpayer would otherwise make in later years. The taxpayer could itemize deductions in the year in which the large payments are made, and use the increased standard deduction in other years.

The aged (age 65 and older) or blind deduction under §63(f) is not eliminated. The Joint Explanatory Statement describes the Senate version: “The additional standard deduction for the elderly and the blind is not changed by the provision,” and the Conference Agreement followed the Senate amendment. The aged or blind indexed deduction has previously been announced as being \$1,300 (\$1,600 for an unmarried person who is not a surviving spouse) for 2018.

(4) **Kiddie Tax.** Under pre-Act law, the earned income of a child is taxed under the child’s single individual rates, but unearned income of a child who is subject to the Kiddie Tax (generally children with unearned income exceeding \$2,100 who are under age 18 and some children up to age 23 meeting certain requirements) is taxed at the parents’ rates if those rates are higher than the child’s rate. The Act continues but simplifies the Kiddie Tax by applying ordinary and capital gains rates applicable to trusts and estates, which often are higher than the parents’ rates, to the unearned income of the child. This change does not affect the ability of the child to take advantage of the \$200,000 threshold for protection from the 3.8% net investment income tax.

(5) **Child Tax Credit.** The Act increases the child tax credit from \$1,000 for each qualifying child under age 17 to \$2,000 (not indexed) and the phase-out would not begin until income exceeds \$400,000 (not indexed) for married taxpayers filing jointly or \$200,000 (not indexed) for other taxpayers. The Act also increases the refundable portion of the credit.

The Act also allows a \$500 (not indexed) nonrefundable credit for qualifying dependents other than qualifying children.

No credit is allowed with respect to qualifying children unless the taxpayer provides the child’s Social Security number.

Because of the substantial increase in the child tax credit, families with multiple children may be among the most likely to realize significant income tax decreases under the Act. The expanded child tax credit provision has a very large revenue impact—projected at \$573.4 billion over ten years.

(6) **Charitable Deduction.** The Act continues to provide that charitable contributions are deductible, with an increased percentage limitation on cash contributions to public charities – i.e., 60% of the “contribution base” (generally AGI with a few modifications), up from 50%. The technical language of the Act, however,

results in the new 60% limit being applicable if only cash gifts are made to public charities; for example, if “one dollar of non-cash assets is donated (such as securities),” the traditional 50% limitation would apply. Letter from AICPA to Congressional Leaders Recommending Technical Corrections to Pub. L. No. 115-97 (February 22, 2018).

The 80% deduction for contributions made for university athletic seating rights is eliminated. In addition, the exception from the substantiation requirement if the donee organization files a return that contains the same required information is repealed, effective for contributions made in taxable years beginning after 2016.

(7) **Home Mortgage Interest Deduction.** Home mortgage interest for acquisition indebtedness of a residence that is incurred after December 15, 2017 is limited to the interest on \$750,000 (down from \$1 million) of debt. The \$750,000 limitation is not indexed. Pre-Act rules apply to acquisition indebtedness incurred prior to that date, and to refinancings of those loans not exceeding the refinanced indebtedness. No deduction is allowed for interest on home equity indebtedness (regardless when incurred) for 2018-2025 (after which time the individual provisions sunset, as discussed in Item 2.e.21 below).

(8) **State and Local Taxes Deduction.** After considerable negotiation, the deduction for state and local income, sales, and property taxes (colloquially referred to as “SALT”) not related to a trade or business or a §212 activity is retained but limited to \$10,000 (not indexed) for joint filers and unmarried individuals and \$5,000 (not indexed) for a married individual filing a separate return (now representing another “marriage penalty” provision in the Code). This limitation may be significant for taxpayers living in high income tax states, and can be a factor in deciding where to establish (or whether to change) one’s domicile.

The \$10,000 limit on SALT deductions has led some states to consider implementing laws providing relief from state income tax to the extent of contributions to a specified charitable fund, in hopes that the taxpayer could deduct the full charitable contribution without any \$10,000 limitation. As an example, a taxpayer in Arizona may donate \$500 to a tax-exempt private school in Arizona and receive a dollar-for-dollar reduction in state income tax liability (up to a maximum of \$500) against the state income tax liability. While the \$500 reduction of state income tax liability might be viewed as a quid pro quo that should reduce the charitable deduction, some authority exists for permitting the full charitable deduction in similar situations. See Chief Counsel Advice 201105010. S.B. 227 is being introduced in California to allow an 85% credit against the personal income tax for amounts contributed to the “California Excellence Fund.”

This limitation might lead to some taxpayers having residences owned by various trusts for various beneficiaries, each of which would have its own \$10,000 limitation for the property tax deduction. See Item 2.e.(8) and Item 2.e.(20)(c) below.

The SALT \$10,000 limitation does not apply to taxes paid “in carrying on a trade or business or an activity described in section 212” (i.e., investment activities), so should not apply to state and local taxes reported on Schedule C (for a trade or business) or Schedule E (net income from rents and royalties).

(9) **Miscellaneous Itemized Deductions Not Deductible.** The Act adds new §67(g) as follows:

(g) SUSPENSION FOR TAXABLE YEARS 2018 THROUGH 2025.—Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.

Section 67(a) provides that “miscellaneous itemized deductions” (described in §67(b)) may be deducted only to the extent they exceed 2% of adjusted gross income (AGI). Miscellaneous itemized deductions are all itemized deductions *other than* those specifically listed in §67(b); the excepted items (which are still deductible) include deductions for payment of interest, taxes, charitable contributions by individuals or trusts and estates, medical expenses, and estate tax attributable to income in respect of a decedent (under §691(c)).

The effect is that the Act, in very few words, eliminates many itemized deductions for taxable years beginning in 2018-2025. The Joint Explanatory Statement summarizes the present law by listing a large number of deductions treated as miscellaneous itemized deductions, and concluding that “taxpayers may not claim the above-listed items” as deductions during the suspension years. (The listed expenses include tax preparation expenses.)

The disallowance of many deductions for individuals may have an impact on state income taxes as well, because many states base their income tax calculation on the federal taxable income.

See Item 2.e.(20)(d) below regarding the impact of this provision on the deductibility of the executor and trustee fees and other expenses of trusts and estates.

(10) **Pease Limitation Eliminated.** The Pease limitation (reducing most itemized deductions by 3% of the amount by which AGI exceeds a threshold amount [\$313,800 in 2017 for married couples] but with a maximum reduction of 80%) is eliminated for 2018-2025. Eliminating the Pease limitation may have little impact for many taxpayers, however, in light of the elimination of most itemized deductions. Eliminating the Pease limitation can still be important for individual taxpayer itemizers who have substantial charitable or home mortgage interest deductions (as well as the SALT deduction, up to \$10,000).

(11) **Qualified Business Income Deduction.** In connection with the decrease of the top corporate tax rate to 21%, a deduction is allowed for individual business owners of businesses operated in pass-through entities (sole proprietorships, partnerships, limited liability companies, or S corporations). The deduction under new §199A is included in the portions of the Act dealing with individuals, but the deduction is discussed in the Business Tax Matters section of this summary, below. The deduction will be a very significant deduction for some business owners.

(12) **Medical Expenses.** The Act retains the medical expense deduction and even expands the deduction for two years by reducing the threshold to 7.5% (rather than 10%) of AGI for 2017-2018.

(13) **Alimony; Repeal of §682.** Alimony payments will not be deductible and will not be income to the recipient. In addition, §682 is repealed; that section provided that if one spouse created a grantor trust for the benefit of the other spouse, following the divorce the trust income would not be taxed to the grantor-spouse under the grantor trust rules to the extent of any fiduciary accounting income that the donee-spouse is “entitled to receive.” The repeal of §682 is particularly troublesome, in part because §672(e) treats a grantor as holding any power or interest held by an individual who was the spouse of the grantor at the time of the creation of such power or interest, so the ex-spouse’s interest as a beneficiary will likely be sufficient to trigger grantor trust status under §677 even following the divorce.

The alimony and repeal of §682 provisions are effective for any divorce or separation instrument executed after December 31, 2018 and any divorce or separation instrument executed before that date but modified after that date if the modification expressly states that the amendments made by this section of the Act apply to such modification. This provision does not sunset after 2025.

This change will have a significant impact on the negotiation of divorce agreements. Many divorce agreements include agreements to pay alimony in order to take advantage of using the recipient spouse’s lower income tax brackets. The inability to shift income tax responsibility for alimony payments or for the income of grantor trusts may have an impact on the negotiated amount of alimony. The Act may create an incentive for spouses who are contemplating divorce to complete the divorce before the end of 2018. *See generally*, Shenkman, Provdor, Blattmachr, & Matak, *Divorce Planning After the 2017 Tax Act*, BNA Daily Tax Report (Feb. 5, 2018).

(14) **Moving Expenses.** The deduction for moving expenses incurred in connection with starting a new job at least 50 miles farther from the taxpayer’s former residence than the former workplace and the exclusion from income of moving expense reimbursements are eliminated for 2018-2025, except for members of the Armed Forces in certain circumstances.

(15) **Alternative Minimum Tax.** The alternative minimum tax (AMT) is not eliminated for individuals, but the AMT exemption for individuals is increased from \$78,750 to \$109,400 (indexed) and the phase-out threshold is increased from \$150,000 to \$1,000,000 (indexed) for married taxpayers filing joint returns.

(16) **Recharacterizing Roth IRAs.** Contributions to Roth IRAs are non-deductible (i.e., are made from after-tax income), but qualified distributions from Roth IRAs are not includible in the recipient’s income. Traditional IRAs may be converted to Roth IRAs, and the amount converted is includible in the taxpayer’s income as if a withdrawal had been made. Under pre-Act law, a Roth IRA that received a contribution or that resulted from a conversion of a traditional IRA could have been recharacterized as a traditional IRA before the due date for the individual’s income tax return for that taxable year. For example, if assets in a Roth IRA decline in value after conversion from a traditional IRA, the Roth IRA could be recharacterized as a traditional IRA to avoid the income recognition from the conversion, and the recharacterized traditional IRA could again be converted to a Roth IRA at the lower values. The Act eliminates the recharacterization option for conversions (but not for

contributions), effective for taxable years beginning after 2017 (and this provision does not sunset after 2025).

(17) **Expanded Application of 529 Accounts.** For distributions after 2017, “qualified higher education expenses” will include tuition at public, private, or religious elementary or secondary schools, limited to \$10,000 per student during any taxable year.

(18) **Life Settlements of Life Insurance Policies.** For viatification (life settlements) of life insurance policies, the Act provides that the taxpayer’s basis in a life insurance policy is not reduced by the “cost of insurance” charges, reversing the IRS position announced in Rev. Rul. 2009-13. Reporting requirements are added for “reportable policy sales,” and none of the transfer for value exceptions apply to such sales. These provisions do not sunset after 2025.

(19) **Eliminate Mandate for Health Insurance.** The Act eliminates the mandate for having qualifying health insurance beginning in 2019 (which is anticipated to save \$318-\$338 billion over 10 years because of reduced federal subsidies to low income persons who purchase coverage). The Congressional Budget Office and Joint Committee on Taxation project that this change will result in 13 million fewer people having health insurance by 2027 and will increase insurance premiums for many Americans by about 10%.

(20) **Provisions Impacting Trusts and Estates.**

(a) **Tax Provisions for Individuals Generally Apply to Trusts.** Section 641(b) provides that “[t]he taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part.”

(b) **Personal Exemption.** In lieu of the deduction for personal exemptions, an estate is allowed a deduction of \$600, a complex trust is allowed a deduction of \$100, and a simple trust (required to distribute all of its income currently) is allowed a deduction of \$300. An exception is made for a “qualified disability trust” which gets a deduction equal to the personal exemption of an individual. While the personal exemption for individuals is repealed, the Act adds new §642(b)(2)(C)(iii) to apply a deduction of \$4,150 (indexed) for qualified disability trusts for years in which the personal exemption for individuals is zero (i.e., 2018-2025). The \$600, \$100, and \$300 deduction amounts for estates and trusts other than qualified disability trusts are not changed by the Act.

(c) **State and Local Taxes.** The \$10,000 limit on deducting state and local taxes under the Act applies to trusts (as made clear in footnote 171 of the Joint Explanatory Statement). This may create some incentive for creating multiple trusts, subject to the anti-abuse provisions for multiple trusts under §643(f), so that each separate trust would be entitled to its own \$10,000 limit on the SALT deduction. Having different beneficiaries or other terms of the separate trusts would be important for avoiding §643(f). Section 643(f) applies for trusts having substantially the same grantors and primary beneficiaries if the principal purpose of the trusts is to avoid income tax, but it applies “under regulations prescribed

by the Secretary” and no such regulations have ever been issued. However, other tax or nontax reasons may exist for having a single trust.

(d) **Executor or Trustee Fees and Other Miscellaneous Estate or Trust Expenses.**

New §67(g) states that “[n]otwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.” Section 67(a) provides that “miscellaneous itemized deductions” (described in §67(b)) may be deducted but only to the extent they exceed 2% of adjusted gross income. Miscellaneous itemized deductions are all itemized deductions *other than* those specifically listed in §67(b), and executor and trustee fees are not listed in §67(b), so does new §67(g) preclude their deduction?

The answer is not clear. Executor and trustee fees and other miscellaneous estate/trust expenses are deductible under §67(e) to the extent that they satisfy the requirement of being expenses that “would not have been incurred if the property were not held in such trust or estate.”

Section 67 does not authorize deductions but limits deductions that would otherwise be allowed under other Code sections. New §67(g) says that miscellaneous itemized deductions are not allowed “notwithstanding §67(a),” but makes no reference to §67(e).

The specific reference to §67(a) but not §67(e) leaves the possible implication that miscellaneous itemized deductions could be allowed under §67(e). Section 67(e)(1) states (independently of §67(a)) that miscellaneous itemized deductions “shall be treated as allowable” in calculating an estate/trust’s AGI as long as the expenses are “paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate,” and §67(e)(2) makes clear that §67 does not limit the deductions for estates or trusts under §§642(b), 651, or 661.

Various arguments have been suggested to support the continued deductibility of miscellaneous deductions for estates and trusts notwithstanding §67(g). One argument is that superseding §67(e) would lead to illogical results. To say that new §67(g) supersedes §67(e) would suggest that it overrides not just §67(e)(1) but also §67(e)(2), which addresses §642(b) (the deduction in lieu of personal exemption), 651, and 661. That would result in the illogical conclusion that §642(b) is overridden although other provisions of the Act provide expanded relief under §642(b), and would also mean that trusts and estates get no distribution deductions (which would completely overturn the basic premise of the income taxation of trusts and estates).

Additionally, the Joint Explanatory Statement describes the addition of §67(g) as suspending “all miscellaneous itemized deductions that are subject to the two-percent floor under present law.” Arguably, therefore, the intent was not to eliminate the deduction of items that were permitted under §67(e) because they are not “subject to the two-percent floor under present law.”

Another argument suggested by Steve Gorin (St. Louis) is that because the deductions are allowable in determining AGI (i.e., they are “above the line”

deductions), they are not “itemized deductions” at all (and therefore not miscellaneous itemized deductions) because of §63(d)’s definition of itemized deductions:

Code §63(d) provides, “For purposes of this subtitle, the term ‘itemized deductions’ means the deductions allowable under this chapter other than (1) the deductions allowable in arriving at adjusted gross income, and (2) the deduction for personal exemptions provided by section 151.” So Code §67(e)(1) recharacterizes those expenses as above-the-line and not being itemized deductions at all. Not being itemized deductions any more, they are not subject to Code §67(a). When Code §67(e) says “for purposes of this section,” it is explaining that its recharacterization of expenses supersedes the definition in subsection (b) that otherwise would have applied to the expenses (described in Code §67(e)(1)) and that therefore these expenses are no longer subject to subsection (a).

...

Nothing [in the Act or the Joint Explanatory Statement] suggests that Code §67(e)(1) has been directly or indirectly repealed as well.

Cathy Hughes, estate and gift tax attorney-adviser in the Treasury Department’s Office of Tax Policy stated at the ABA Tax Section meeting in February, 2018 that the deductibility of trustee and executor fees will be one of Treasury’s first estate-related tax law projects. She stated “I can’t promise when it’s going to be out, but that’s probably one of the first things you’ll see.” See Allyson Versprille, *Fee Deductions to Be Among First Estate, Trust Law Projects*, BNA DAILY TAX REPORT Feb. 13, 2018).

(e) **Excess Deductions or Losses at Termination of Estate or Trust.** Section 642(h)(1) provides that on the termination of an estate or trust, a net operating loss or capital loss carryover shall be allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust. Capital losses are not itemized deductions, so new §67(g) should not impact them.

On the other hand, §642(h)(2) states that on the termination of an estate or trust any deductions for the last taxable year of the estate or trust (other than the deduction in lieu of personal exemptions and other than the charitable deduction) in excess of gross income for the year shall be allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust. Those deductions are not mentioned in §67(b) and are miscellaneous itemized deductions, therefore their deduction is not allowed for 2018-2025 under new §67(g). Indeed the Joint Explanatory Statement specifically includes “[e]xcess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust” as one of the “above listed items” that cannot be claimed as a deduction under §67(g). The discussion about *estate/trust* deductions in paragraph d above does not apply, because these are deductions to the individual beneficiaries, not to the trust.

If the assets of an estate or trust pass to an individual and if the excess deductions are miscellaneous itemized deductions, the individual beneficiary would not be able to use those miscellaneous itemized deductions because of §67(g). If instead, the assets of the terminating estate or trust pass to another trust, can they deducted by the recipient trust under §67(e)? Presumably not,

because §67(e)(1) seems to refer to expenses incurred in the administration of the estate or trust claiming the deduction.

(f) **Alternative Minimum Tax.** The Act increases the AMT exemption for individuals, but not for trusts and estates. The exemption amounts for trusts and estates will likely be slightly lower than the previously announced amounts for 2018 because of the Act's requirements to use chained CPI indexing.

(g) **Section 691(c) Deduction for Estate Taxes Attributable to Income in Respect of a Decedent.** New §67(g) does not suspend the §691(c) deduction for estate tax attributable to income in respect of a decedent because the §691(c) deduction is one of the items listed in §67(b) as *not* being a miscellaneous itemized deduction "for purposes of this section," which would include new §67(g).

(h) **Electing Small Business Trusts.**

(1) **NRA as Permitted Potential Beneficiary.** The Act allows a nonresident alien (NRA) individual to be a potential current beneficiary of an electing small business trust (ESBT).

(2) **Charitable Deduction Allowed Under §170 Rather Than §642(c).** The charitable contributions deduction for trusts is governed by §642(c) rather than §170, which governs the charitable deduction for individuals. Several restrictions that apply under §642(c), but not under §170, are that the distribution must be made from gross income and pursuant to the terms of the governing instrument (and the governing instrument requirement has been applied strictly). In addition, no carryover of excess contributions is allowed for trusts. The Act provides that the charitable contribution deduction of an ESBT is determined by rules applicable to individuals under §170, not the rules applicable to trusts under §642(c), effective for taxable years beginning after 2017. This will be favorable in various respects for charitable contributions made by the portion of an ESBT holding S corporation stock. Eliminating the gross income requirement means that a charitable deduction would be available for gifts of property, the same as for individuals. The governing instrument requirement will no longer apply. Excess charitable deductions can be carried forward for five years. Possible negative effects of applying §170 rather than §642(c) to ESBTs are that the percentage limitations (but also the carryforward provisions) applicable to individuals will apply to charitable contributions made by the portion of an ESBT holding S corporation stock, and the substantiation requirements that apply to individuals under §170 will also be applicable to ESBTs, effective for taxable years beginning after 2017.

(3) **No Sunset.** The changes described above for ESBTs are permanent and do not sunset after 2025.

(4) **Section 199A Deduction.** ESBTs appear to qualify for the §199A deduction, discussed in Item 2.f.(2)(c) below.

(21) **Sunset after 2025** – Almost all of the individual income tax changes will expire after 2025. This includes (among the many individual tax changes) the deduction for

business income from pass-through entities, individual rate cuts, expanded child tax credit, expanded standard deduction, repeal of personal exemptions, and increases in the transfer tax exclusion amounts. A few (very few) of the individual income tax changes do not sunset after 2025, including the use of the chained CPI, which has the effect of moving taxpayers into higher brackets in future years as compared to the current indexing approach, alimony and §682 repeal, recharacterization of Roth IRA conversions, and the life insurance settlement provisions.

(22) **“Five Year Rule” On Mandatory Distributions From Qualified Plans and IRAs Not Included.** The Senate Finance Committee on September 21, 2016 *unanimously* approved the Retirement Enhancement and Savings Bill of 2016, which among other things would have required that distributions from qualified plans and IRAs be made within five years of the death of the participant, with limited exceptions (one being for a surviving spouse) to the extent all of an individual’s plans exceed \$450,000. Despite Congress’s focus on finding revenue to offset the tax cuts in the Act, this provision is not included.

The issue will likely arise again at some point. For a further discussion of the provisions in that Retirement and Enhancement and Savings Bill of 2016, see Item 2.g of the Estate Planning Current Development and Hot Topics Summary (October 2017), found [here](#) and available at www.Bessemer.com/Advisor.

f. **Business Tax Matters.**

(1) **Corporate Tax Rate.** The top corporate tax rate is 21% under the Act, effective beginning in 2018. This reduced top income tax rate applies to any entities that are subject to income taxation under Subchapter C.

(2) **Qualified Business Income from Pass-Through Entities.** A complicated provision in new §199A provides tax-favored treatment of business income from pass-through entities (sole proprietorships, partnerships, limited liability companies, or S corporations) that are not subject to taxation under Subchapter C and that will be taxed at the individual tax rates of the owners, which could be as high as 37%. The tax advantage under §199A reduces the wide discrepancy (21% vs. 37%) in the top rates at which business income would be taxed, depending on whether the business is taxed as a corporation or as a pass-through entity. Very generally (but with various limitations and exceptions), the §199A deduction results in a top rate of 29.6% (as discussed below) for the taxation of business income from pass-through entities. The provision is in the Subtitle A of the Act addressing individual tax reform (in particular in Section 11011 of the Act), but is included in the business tax portion of this summary.

(a) **Overview of Deduction.** Way overly simplified –

(1) **20% Deduction; Wage Limitation.** The Act allows a deduction equal to 20% of qualified business income from pass-through entities, limited to 50% of the taxpayer’s pro rata share of the total W-2 wages paid by the business (including wages paid to the taxpayer). The Joint Explanatory Statement explains that the W-2 wages limitation is meant to “deter high-income

taxpayers from attempting to convert wages or other compensation for personal services to income eligible for the 20-percent deduction.” The 20% deduction results in an effective top rate of $(1 - 0.20) \times 37\%$, or 29.6%.

(2) **Qualified Business Income.** Qualified business income is generally the net amount of income, gain, deduction, and loss from an active trade or business within the United States, but not including certain types of investment income (capital gains, dividends or interest unless the interest is allocable to a trade or business), and not including reasonable compensation paid to the taxpayer, any guaranteed payment under §707(c), or payment to a partner for services under §707(a). A net loss from a particular business in one year carries over to the next taxable year as a loss for that business.

Will reasonable compensation concepts still apply in determining what constitutes qualified business income? Reasonable compensation concepts are applied to S corporations to prevent avoidance of employment tax abuses, but no rules require partnerships to pay their active owners a guaranteed payment. Officials have indicated informally that the Treasury Department is considering whether it should apply reasonable compensation rules to partners and proprietors, as well as S corporations, for purposes of the §199A deduction. *See Davison, Treasury Mulls Applying Reasonable-Compensation Rules to Partners*, BNA Daily Tax Report (Feb. 12, 2018). Any earnings treated as compensation do not qualify for the §199A deduction.

(3) **“Real Estate Exception” to Wages Limitation.** The wages limitation was relaxed in the Conference Agreement by adding that the wage limitation is the greater of (a) 50% of W-2 wages, or (b) the sum of 25% of W-2 wages plus 2.5% of the unadjusted basis, immediately after acquisition, of all tangible property subject to depreciation (which could be very beneficial to real estate companies).

(4) **Specified Service Companies.** The deduction does not apply for specified service businesses in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any business where the principal asset is the reputation or skill of one or more of its employees (by reference to §1202(e)(3)(A)), except for engineering or architecture. This provision decreases the incentive of specified service businesses to pay low compensation income for the service-provider employees and claim that most of the income from the business is qualified business income entitled to the 20% deduction.

Mark Prater, deputy staff director and chief tax counsel for the Senate Finance Committee, has explained that “[t]o the extent we didn’t draw clear lines with respect to compensation-heavy businesses, we knew we were going to have problems.... You find that you have to draw something of a line between the compensation-heavy businesses and the conventional businesses that have a mix of markup on inventories, related services, or

asset-based income, etc.” See Laura Davison, *Architects, Engineers Will Get Pass-Through Tax Break: Official*, BNA DAILY TAX REPORT (Feb. 5, 2018).

(5) **Exceptions for Lower Income Taxpayers.** The 50% wage limitation (as modified by the “real estate” exception summarized above), and the specified service limitation do not apply if the taxpayer has taxable income below a threshold amount of \$315,000 (indexed) for married individuals filing jointly and \$157,500 (indexed) for other taxpayers, with a phase-out of the deduction for taxpayers over the next \$100,000/50,000 of taxable income. The \$157,500 threshold is *taxable* income, which would be calculated after taking the individual’s \$24,000 standard deduction and 50% of self-employment taxes.

(6) **REIT, Publicly Traded Partnership, Qualified Cooperative Dividends.** A straight 20% deduction generally applies to qualified REIT dividends, qualified publicly traded partnership income, and qualified cooperative dividends (subject to the overall limit described below of taxable income less net capital gains). In effect, the wage limitation does not apply to those types of income.

(7) **Trusts and Estates.** The deduction is available to non-corporate taxpayers, including trusts and estates. (The Senate version would not have made the deduction available to trusts and estates.) In applying the wage limitation, W-2 income from entities owned by trusts and estates is apportioned between beneficiaries and the fiduciary under §199(d)(1)(B)(i), which has the effect of applying the rather complicated rules in Reg. §1.199-9(d)-(e).

(8) **Deduction Cannot Exceed Taxable Income Less Net Capital Gain.** The deduction cannot exceed taxable income reduced by the taxpayer’s net capital gain for the year. In effect, the 20% deduction cannot exceed the taxpayer’s ordinary and qualified dividend income.

(9) **No Reduction of AGI; Deduction Available to Non-Itemizers.** The deduction reduces taxable income, but not AGI (so the deduction does not affect limitations throughout the Code based on AGI). The deduction is available to both itemizers and non-itemizers. (In other words, the deduction is available in addition to the standard deduction.)

(b) **A Little More Detail.** The details get *much more complicated*. Section 199A(a) describes generally the amount of the deduction, subject to a variety of definitions, modifications, special rules, and anti-abuse rules described in §199A(b)-(h). The Conference Agreement summarizes the deduction amount as follows:

The taxpayer’s deduction for qualified business income for the taxable year is equal to the sum of (a) the lesser of the combined qualified business income amount for the taxable year or an amount equal to 20 percent of the excess of taxpayer’s taxable income over any net capital gain and qualified cooperative

dividends, plus (b) the lesser of 20 percent of qualified cooperative dividends and taxable income (reduced by net capital gain). This sum may not exceed the taxpayer's taxable income for the taxable year (reduced by net capital gain). Under the provision, the 20-percent deduction with respect to qualified cooperative dividends is limited to taxable income (reduced by net capital gain) for the year. The combined qualified business income amount for the taxable year is the sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer and 20 percent of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income. The deductible amount for each qualified trade or business is the lesser of (a) 20 percent of the taxpayer's qualified business income with respect to the trade or business, or (b) the greater of 50 percent of the W-2 wages with respect to the trade or business or the sum of 20 percent of the W-2 wages with respect to the trade or business and 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

Got all that? (And that is a VERY simplified summary of the actual statute.) The headings of the subparagraphs of §199A provide an indication of the many detailed provisions in the statute: (b) Combined Qualified Business Income Amount; (c) Qualified Business Income, (d) Qualified Trade or Business; (e) Other Definitions; (f) Special Rules; (g) Deduction Allowed to Specified Agricultural or Horticultural Cooperatives; and (h) Anti-Abuse Rules. For a more detailed description of the detailed operation of §199A(a) with examples, see Avi-Yonah, Batchelder, Fleming, Gamage, Glogower, Hemel, Kamin, Kane, Kysar, Miller, Shanske, Shaviro, & Viswanathan, *The Games They Will Play: An Update on the Conference Committee Tax Bill* (December 22, 2017) (excellent discussion of specific strategies including "cracking" and "packing" strategies for specified service companies); Samuel Donaldson, *Understanding the Tax Cuts and Jobs Act* (2018); Alan Gassman & Brandon Ketron, *Dymistifying the New Section 199A Deduction for Pass-Through Entities*, LEIMBERG INCOME TAX PLANNING NEWSLETTER #125 (January 4, 2018); Leimberg, Geeraerts, & Magner, *Tax Cuts and Jobs Act of 2017 – What Advisors Need to Know to Better Inform Their Clients*, LEIMBERG ESTATE PLANNING NEWSLETTER #2609 (December 16, 2017); Tony Netti, Tax Geek Tuesday: Making Sense of the New '20% Qualified Business Income Deduction,' *Forbes* (Dec. 6, 2017);

<https://www.forbes.com/sites/anthonymitti/2017/12/26/tax-geek-tuesday-making-sense-of-the-new-20-qualified-business-income-deduction/#775b9e8e44fd>.

(c) **ESBTs Qualify for §199A Deduction.** The statute and legislative history do not specifically address the availability of the §199A deduction for ESBTs, but they presumably qualify for the deduction. Section 641(c) describes the manner in which the taxable income and the tax is determined for ESBTs, and §641(c)(2)(C) states that only certain items of income, loss, deduction, or credit may be considered in determining the tax for ESBTs, but the few allowed items include "[t]he items required to be taken into account under section 1366." Section 1366 describes the pass-through of items to S corporation shareholders,

which would include the pass-through of business income that would be reported on the Schedule K-1 from the S corporation.

(d) **Revenue Impact.** The Joint Committee on Taxation projects that the deduction for business income from pass-through entities will cost \$414.4 billion over ten years, which suggests that the provision will present substantial planning and tax savings opportunities for taxpayers who can take advantage of the deduction.

(e) **Proposed Regulations Coming.** Dana Trier, the Treasury Department's deputy assistant secretary for tax policy, has indicated that Regulations outlining what income qualifies is a high priority at Treasury, and the first draft will come out as a proposed regulation. He acknowledged that the regulations will be controversial. "The way I envision it is: You suck it up. You get out a reg package that deals with that. People all over the country will be mad at us. We react to that. We go forward." Among other things, it will deal with how to treat two businesses that operate within one entity, and businesses that convert employees into partners to take advantage of the deduction. See Laura Davison, *Architects, Engineers Will Get Pass-Through Tax Break: Official*, BNA DAILY TAX REPORT (Feb. 5, 2018).

A letter from the AICPA to the IRS identifies a number of areas requiring guidance regarding the 2017 Tax Act. With respect to §199A, the letter identifies the following issues:

- Guidance is needed on the meaning of specified service trade or business as defined in section 199A(d)(2) namely, any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners, or any trade or business which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).
- The calculation of QBI when flowing through multiple tiered entities.
- The netting computation of losses from one business against gains from another business.
- The effect of existing grouping (such as under section 469) of trades or businesses for purposes of the limitations based on W-2 wages, adjusted basis of assets, and specified service business. For example, if grouping is allowed, will taxpayers have an opportunity to regroup their trades or businesses to take advantage of the deduction?
- Whether wages are determined similar to the concepts provided in Treas. Reg. section 1.199-2(a)(2) (consider wages of the common law employees, regardless of who is responsible for the payment of the wage). Whether a trade or business is defined as an activity within an entity. For example, what if an entity has two clearly separate trades or businesses?
- Whether all similar qualified businesses are aggregated for purposes of the calculation or if each business is evaluated separately. Clarity is needed, for taxpayers with non-qualified business activities, as to whether or not there is a de minimis percentage at which the

activity is not excluded, or whether the taxpayer makes separate computations for the personal service activity versus the non-personal service activity.

- Whether the taxpayer may consider a management company an integral part of the operating trade or business (and thus, not a specified business activity) if substantially all of the management company's income is from that other trade or business.
- The qualification of real property rental income as qualified business income (or loss).
- If grouping is allowed, whether taxpayers may treat the rental of real estate to their related C Corporation (e.g., a self-rental) as trade or business income.
- The determination of items effectively connected with a business, e.g., section 1245 gains and losses, retirement plan contributions of partners and sole proprietors, the section 162(l) deduction and one-half of self-employment tax.
- The unadjusted basis of assets expensed under section 179 or subject to bonus depreciation.
- The unadjusted basis of assets held as of January 1, 2018.
- The unadjusted basis of property subject to 743(b) basis adjustments.
- The effect, if any, of the 20% deduction on net investment income tax calculations.

Letter from Annette Nellen, Chair, AICPA Tax Executive Committee to The Honorable David J. Kautter, Assistant Secretary for Tax Policy and William Paul, Principal Deputy Chief Counsel and Deputy Chief Counsel (Technical, dated January 29, 2018).

(3) **Increased Section 179 Expensing.** Under pre-Act law, taxpayers could generally deduct the cost of depreciable tangible personal property and certain real property purchased for use in a trade or business, but only up to \$500,000 (indexed) reduced by the cost of qualifying property placed in service during the year in excess of \$2 million (indexed). The balance of the cost is depreciated over an applicable period of years. The Act increases the allowed expensing levels to \$1 million, and the phase-out threshold amount is increased to \$2.5 million.

(4) **100% Expensing for Qualifying Business Assets.** Under pre-Act law, an additional first-year depreciation deduction is allowed equal to 50% of the adjusted basis of qualified property placed in service before 2020 (subject to various qualifications). The Act allows 100% expensing for qualified property (generally, depreciable assets other than buildings) that is acquired and placed in service after September 27, 2017 and before 2023 (before 2024 for “longer production period” property and certain aircraft), and extends the expensing to the acquisition of used as well as new property. A 20% per year phase-down of full expensing will apply for property placed in service after 2022 and before 2027.

(5) **Interest Deductions for Businesses.** Interest deductions for businesses with average annual gross receipts over \$25 million for the three prior years generally are limited under the Act to 30% of the corporation's adjusted taxable income computed before interest, taxes, depreciation, amortization or depletion deductions (“EBITDA”) or any deduction under new §199A for qualified business income of a pass-through entity for taxable years beginning after 2017 and before 2022, and for later taxable years from a smaller amount (still without considering any deduction under §199A), earnings before interest and taxes (EBIT). Disallowed interest can be carried forward

indefinitely. Various complicated detailed rules and exceptions apply in determining the interest deduction limitation, but the limitation will be significant.

(6) **Corporate Alternative Minimum Tax Repealed.** The corporate alternative minimum tax is repealed. A planning implication is that one of the possible disadvantages of having corporate owned life insurance to fund an entity-purchase buy sell agreement will be removed, which could impact the decision of whether to use an entity-purchase or cross-purchase arrangement for corporate buy-sell agreements.

(7) **Like-Kind Exchanges Limited to Real Property.** Like-kind exchanges are permitted for property held for use in a trade or business or for investment. Under pre-Act law, like-kind exchanges are permitted for real or personal property. Under the Act, like-kind treatment will be limited to real property.

(8) **Entertainment Expenses.** No deduction will be allowed for expenses of a trade or business related to entertainment, amusement, or recreation activities or for membership dues to any club organized for business, pleasure, recreation, or other social purposes. The 50% limitation on deductions continues to apply for meals associated with operating the trade or business. The Joint Explanatory Statement gives this example: "(e.g., meals consumed by employees on work travel)."

(9) **Net Operating Losses.** Net operating losses (NOLs) are deductible only up to 80% of taxable income (determined without regard to the deduction). Under pre-Act law, they were fully deductible. NOLs cannot be carried back to prior years, as was permitted under pre-Act law, but indefinite carryforwards will continue to be allowed.

(10) **Qualified Stock Options.** Employees who receive stock options or restricted stock for the performance of services may defer recognition of income for up to five years upon exercise of the options (or earlier when the qualified stock becomes transferable or readily tradable on an established securities market). The special deferral provision does not apply to a 1% owner of a corporation, a CEO or CFO, any of the four highest compensated officers for any of the 10 preceding years, and family members of a 1% owner, CEO, or CFO.

(11) **Carried Interest.** A 3-year holding period will apply in order for certain partnership interests received in connection with the performance of services to be taxed as long-term capital gain. The 3-year holding period requirement applies notwithstanding the rules of §83 or whether a §83(b) election was made.

(12) **Deemed Partnership Termination.** A sale of 50% or more of the capital and profits of a partnership will no longer result in a technical termination of the partnership.

g. **Tax-Exempt Organizations.**

(1) **UBTI Determined Separately For Each Activity.** New §512(a)(6) provides that the unrelated business taxable income (including for purposes of determining any NOL deduction) is determined separately for each trade or business activity.

A loss from one activity cannot offset the income from another activity in determining the organization's UBTI, but a loss from an activity in one year can offset the income from the same activity in another year. (This provision has been troubling for some non-exempt organizations. See Item 4.a below.) Under a special transition rule, NOLs that arise in taxable years beginning before 2018 that are carried over to a later year are not subject to this new limitation.

(2) **Excise Tax for Certain Private Colleges and Universities.** A 1.4% of net investment income excise tax applies to private colleges and universities that have more than 500 students, assets of at least \$500,000 per full-time student, and 50% of tuition paying students located in the United States. This provision will apply to only a very limited number of private colleges and universities.

3. Estate Planning Considerations In Light of New Legislation and Inherent Uncertainty Arising From 2026 Sunset

- a. **Déjà Vu on Steroids.** Planning alternatives that were considered in 2013 following the passage of ATRA, when the gift tax exclusion amount increased from \$1 million to \$5 million have resurfaced in light of the doubling of the gift tax exclusion. Indeed many of the detailed planning issues summarized in the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at www.Bessemer.com are highly relevant for 2018.
- b. **Paradigm Shift.** The increased \$10 million (indexed) estate and gift tax basic exclusion amount for every individual means that estate and gift taxes are irrelevant for most clients. Concepts that have been central to the thought processes of estate planning professionals for their entire careers are no longer relevant for most clients – even for “moderately wealthy” clients (with assets of over several million dollars). For example, structuring trusts to qualify for the gift tax annual exclusion may be unnecessary for many clients who will *never* have any gift or estate tax concerns (though professional advisers must still advise them of the requirement to file gift tax returns reporting any taxable gifts that do not qualify for the annual exclusion). Structuring testamentary charitable trusts to qualify for the estate tax charitable deduction under §2055 will no longer be important for many clients. It is hard for “old dogs to learn new tricks,” and planners will constantly have to be sensitive to the major paradigm shift resulting from the Act.
- c. **Small Percentage of Population Subject to Transfer Taxes.** The Joint Committee staff estimate that only about 1,800 of 2018 decedents will have to pay estate tax (with an estate tax exclusion amount of about \$11.2 million), down from about 5,000 decedents in 2017 (when the estate tax exclusion amount was \$5.49 million). About 2.7 million people died in the U.S. in 2017; thus about 0.067% of decedents pay estate tax, or about 1 in 1,500 decedents. See Heather Long, *3,200 Wealthy Individuals Wouldn't Pay Estate Tax Next Year Under GOP Plan*, Washington Post (Nov. 5, 2017) (based on analysis of Joint Committee on Taxation). The \$10 million (indexed) gift tax exclusion amount also means that many individuals have no

concern with lifetime gifts ever resulting in the payment of federal gift taxes. Wealthy clients still exist, though, and the wealthy are getting wealthier.

- d. **Non-Resident Alien Individuals.** The exclusion amount has NOT increased for non-resident alien individuals (NRAs). The exclusion amount remains at \$60,000 (see §2102(b) (unified credit of \$13,000, which is the amount of tax on a \$60,000 estate)). Do not be lulled into thinking that federal estate tax concerns have vanished for NRAs because of the large increase in the exclusion amount that applies to citizens or residents of the United States.
- e. **Cannot Ignore GST Tax.** Even low to moderate-wealth individuals cannot ignore the GST tax. Without proper allocation of the GST exemption (also \$10 million indexed), trusts created by clients generally will be subject to the GST tax at the death of the beneficiary unless the trust assets are included in the beneficiary's gross estate. Sometimes the allocation will occur by automatic allocation, but the planner must be sure that proper GST exemption allocation is made to long-term trusts (unless the trust assets will be included in the beneficiary's gross estate) even though the purpose of the trusts is not to save transfer taxes. The planner might specifically structure trusts that will not qualify for automatic allocation so that the assets will be included in a beneficiary's gross estate if the beneficiary dies before the termination of the trust, if the planner anticipates that the beneficiary will have sufficient estate tax exclusion amount to eliminate estate tax for the beneficiary even with the trust assets included in the estate (and the inclusion of those assets would also be helpful for basis adjustment purposes, as discussed in Item 3.i.(2) below).

Grantors who have previously created irrevocable trusts that are not fully GST-exempt may want to allocate some of the increased GST exemption amount to the trust. Presumably this is permitted, but the increased estate and gift tax exclusion amount (which is also the GST exemption amount under §2631(c)) applies to "estates of decedents dying and gifts made after December 31, 2017," and the mere allocation of GST exemption to an existing trust is neither of those things.

- f. **Review Formula Clauses.** Review formula clauses in existing documents. For example, a classic bequest to a credit shelter trust of the maximum amount possible without incurring estate taxes may become a bequest of the entire estate if the decedent's estate is less than the \$10 million (indexed) basic exclusion amount. Confirm that is the client's intent. Having all of the estate pass to a credit shelter trust may also generate state estate taxes at the first spouse's death, as discussed in Item 3.g.(10) below. Planners may want to send letters to clients warning them that plans should be reviewed in light of the major impact that the substantial increase in the transfer tax exclusion amounts can have on estate plans.
- g. **Testamentary Planning.** What testamentary planning approaches are preferred for couples with combined assets well under the approximately \$22 million estate tax exclusion amounts available to the spouses?

As an overview of general planning themes depending on the size of the estate of a married couple:

(1) Couples with assets under \$5.5 million – address whether assets will be left outright to the surviving spouse or in trust, and cause estate inclusion at the surviving spouse’s subsequent death to receive a basis adjustment;

(2) Couples with assets over \$5.5 million but less than \$11 million – make use of the first decedent-spouse’s exclusion amount with an outright gift with disclaimer planning or a QTIPable trust approach, creating flexibility through the manner in which the portability election is made (the portability election could create the possibility of using both spouses’ exclusion amounts but allowing a basis adjustment of all of the estate assets at the second spouse’s death); and

(3) Couples with assets over \$11 million – same as category 2 but also consider gifts using some of the increased gift exclusion amount to save estate tax in case the exclusion amount is subsequently reduced back to \$5.5 million and consider making transfers in a way that one or both spouses have potential access to some of the transferred assets for clients making large transfers.

These themes are addressed in more detail below. The alternatives begin with the simplest approaches, from a client perspective, but *not necessarily the preferred approaches*.

(1) **Outright-to-Spouse.** For clients who want simplicity and do not want to take advantage of the opportunities available with trust planning, the first decedent-spouse’s assets could be left outright to the surviving spouse at the first spouse’s death. Before employing this “maximum simplicity” approach, the planner should make sure that the client is aware of important planning opportunities that will be lost by not using trust protections for the surviving spouse. (The outright-to-spouse plan can also be disadvantageous in states with state estate taxes with exemptions low enough that the state estate tax might apply at the second spouse’s death.)

(2) **Make Clients Aware of Trust Advantages.** Planners should make sure that clients are aware of various advantages of trusts even if the client has no federal transfer tax concerns. Potential advantages that will be important to some clients are opportunities to provide for appropriate management of assets, to place appropriate limitations on how assets can be used for beneficiaries, to allow the settlor to lock-in who will receive trust assets at the termination of the trust, to protect trust assets from claims of the beneficiaries’ creditors, and to protect trust assets from claims of divorcing spouses or ex-spouses of beneficiaries. In addition, trusts may result in significant state transfer tax or state income tax savings.

Trust structuring should incorporate planning for flexible provisions to react to future conditions. Powers of appointment are becoming increasingly popular for various reasons in facilitating future flexibility.

(3) **Outright Bequest with Disclaimer to Trust.** The first decedent-spouse’s assets could be left outright to the surviving spouse with a disclaimer provision causing the disclaimed assets to pass into a trust with the spouse (and perhaps others) as discretionary beneficiaries.

Several significant disadvantages may result from relying on the disclaimer approach. The most important is that the spouse may refuse to disclaim assets (or may be incompetent or may die before disclaiming), even though a disclaimer would be appropriate based on the tax situation. Another significant disadvantage to the disclaimer approach is that the surviving spouse cannot retain a nontaxable 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, the risk exists that the surviving spouse inadvertently accepts benefits, making a disclaimer impossible. 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 will be treated as disallowed transfers for Medicaid qualification purposes.

In states with a state estate tax, the surviving spouse could disclaim an amount that would not be subject to state estate tax at the first decedent-spouse's death. This decision may be made in a more granular manner by disclaiming assets that either will be held for a very long time period after the surviving spouse's life expectancy, or that are not likely to have significant appreciation potential (again keeping in mind that the income tax cost of not getting a basis step-up at the second spouse's death may outweigh the potential state estate tax).

(4) Direct Bequest to Discretionary Trust For Spouse (And Perhaps Others) For Combined Estate Under \$5 Million. If the surviving spouse wants to take advantage of opportunities available with trusts, the first decedent-spouse's assets might be left directly to a trust permitting discretionary distributions to the surviving spouse (and perhaps other beneficiaries, as well). If the combined estate is under \$5 million, so that no estate tax will result at the second spouse's death even if the second spouse dies after the increased estate tax basic exclusion amount has sunset back to \$5 million (indexed), the trust could be designed to include any provisions desired by the clients, without the necessity of assuring that the trust qualifies for the estate tax marital deduction. A method for causing estate tax inclusion at the second spouse's death may be important to achieve a basis adjustment for the trust assets at the second spouse's death. (See Item 3.i.(2) below.)

(5) Taking Advantage of First Decedent-Spouse's Exclusion Amount For Combined Estate Over \$5 Million. For the couple with over \$5 million, being able to make use of the first decedent-spouse's estate exclusion may be important (if the second spouse dies after the time that the exclusion has declined back to \$5 million (indexed)). That can be accomplished either by leaving assets into a trust that can act as a traditional credit shelter trust or by making the portability election following the first spouse's death. If the portability approach is used, the assets should pass in a manner that qualifies for the marital deduction, or else little DSUE may be available for the surviving spouse even if the portability election is made.

(6) **Increased Importance of Portability.** If the first spouse dies before 2026 while the estate tax basic exclusion amount is still \$10 million (indexed), making the portability election should leave the surviving spouse with a DSUE of that full amount even if the basic exclusion amount later decreases in 2026. See Reg. §20.2010-2(c) (describing computation of DSUE amount).

Unless strong reasons exist to use credit shelter trusts in \$10 million and under estates, relying on portability to take advantage of the first spouse's estate exclusion amount is increasingly helpful. The decision of whether to create a bypass trust following the first spouse's death can be delayed until after the first spouse has died using a disclaimer approach (Item 3.g.(2) above) or using a QTIPable trust (Item 3.g.(7) below), so that the tax law situation at that time can be considered (*e.g.*, whether the exclusion amount has returned to or is still likely to return to \$5 million (indexed) in 2026).

A tax advantage of relying on portability rather than creating a bypass trust is that the surviving spouse has both spouses' exclusions to cover any estate taxes that might apply, 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 and the federal estate tax might apply to the surviving spouse's estate, (ii) a state estate tax, (iii) a younger client scenario (in which remarriage of the surviving spouse is likely), and (iv) 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 (although the surviving spouse may be able to receive trust distributions from a QTIP trust and make gifts to younger family members as desired in light of the increase gift tax exclusion amount). The credit shelter trust may also be advantageous for various reasons in blended family situations, as discussed in Item 8.d the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

If the QTIP approach is used in connection with portability, in light of the wide ranging factors that must be considered and the inherent uncertainties involved with the portability decision, documents should provide broad exculpation to the fiduciary who must make the QTIP election.

(7) **Flexible QTIP Trust Approach.** A favored approach of many planners for testamentary planning will be the use of QTIP trusts, and the approach can be used for any size of estate if the clients want to use trust planning after the first spouse's death. QTIP planning could use a single QTIP plan, or multiple QTIP trusts (for example, if a state estate tax applies with an exemption different than the federal estate tax exclusion amount, as discussed in Item 3.g.(10) below). An advantage of the single QTIP drafting approach is that the client (hopefully) can understand it and realize that it leaves a great deal of flexibility after the first spouse has died.

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 §2652(a)(3)), and a bypass trust approach would be used if a partial QTIP election is made.

The trust could include a Clayton provision allowing more flexible terms if the QTIP election is not made, as discussed in the "Flexibilities" discussion below. Alternatively, the unelected QTIP trust could remain as a single-beneficiary mandatory income trust for the spouse. The amount of income paid to the spouse could be managed by the asset selection for the trust.

Estates under \$5 Million. The approach could be used for combined estates under \$5 million as a way of creating a trust that would be entitled to a basis adjustment at the surviving spouse's subsequent death—but an estate tax return would have to be filed following the first spouse's death to make the QTIP election, as discussed immediately below.

For estates that are small enough that an estate tax return would not be required at the first spouse's death, a disadvantage of the QTIP trust approach is that an estate tax return would have to be filed at the first spouse's death to make the QTIP election. Perhaps the trust could build in the possibility of causing the surviving spouse to have a testamentary general power of appointment at the surviving spouse's subsequent death, or to give the spouse a testamentary nontaxable power of appointment that could be exercised in a manner to trigger the Delaware tax trap, so the option would exist to avoid filing an estate tax return following the first spouse's death to make the QTIP election. In that case, while a basis adjustment would not apply at the second spouse's death because the trust is a QTIP trust (see §1014(b)(10)), it would apply for other reasons.

Estates over \$5 Million. This approach could also be helpful for combined estates in the \$5-\$10 million range because qualifying for the marital deduction is important for those estates, in case the surviving spouse dies after the basic exclusion amount has reverted to \$5 million (indexed).

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

- The executor has up to 15 months to decide whether to make the QTIP election and over what portion of the trust.
- The QTIP election could be made by a formula, thus providing a "savings clause" to assure that no estate tax would be paid at the first spouse's death (if his or her assets are over the new \$10 million basic exclusion amount – or \$5 million exclusion amount after the increased exclusion amount has sunset).
- If the QTIP election is made, the executor could make the "reverse-QTIP" election and allocate the decedent's GST exemption to the trust.

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- 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 exclusion amount without paying any state estate taxes at the first spouse’s death.
 - Any unelected portion could pass to a standard bypass trust under a “Clayton” provision. Some planners believe that the surviving spouse should not be the executor making the QTIP election if there is a Clayton provision. The IRS might argue that if the spouse makes the election, the spouse makes a gift of some or all of the assets that would have been in the QTIP trust. Commentators generally believe 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 concerning whether a gift results and whether that causes §2036 inclusion issues for some portion of the credit shelter trust. But keep in mind the paradigm shift resulting from the huge \$10 million exclusion amount. Many clients will have absolutely no risk of owing gift tax and may be unconcerned about potential gift risks of having the surviving spouse serve as the executor with a Clayton provision. A disadvantage of including a Clayton provision is that leaving the unelected portion in a trust with “QTIPable terms” (including a mandatory income interest for spouse as the exclusive beneficiary) would facilitate getting a “previously taxed property credit” under §2013 if the surviving spouse were to die shortly after the first spouse to die if the estate is large enough to have estate tax concerns. But many clients like being able to make transfers to children and like the income-shifting effect of distributions to the children.
 - The surviving spouse can have a testamentary nontaxable power of appointment over the assets in the QTIP trust (or the Clayton bypass trust).

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

(9) **Creative Flexible Approaches Using Both Disclaimers and QTIP Trusts.** A possible approach involving a QTIP trust and disclaimers is as follows.

- The executor would have 15 months to decide whether to make the QTIP election over all or a portion of the QTIP trust. Any unelected portion could pass to a bypass trust under a “Clayton” provision. If the QTIP election were made, the portability election would be made for the decedent’s unused exemption amount.
- If the spouse disclaims an interest in the QTIP trust, the disclaimed assets would pass outright to the surviving spouse. This “reverse-disclaimer” approach has the significant advantage of allowing the surviving spouse to have a testamentary limited power of appointment over both the QTIP trust and the bypass trust.
- This is a twist from the typical operation of a disclaimer, but the disclaimer rules do not seem to preclude this sort of approach in which the disclaimant receives a greater interest in the property than under the bequest that was disclaimed. Under §2518(b)(4)(A), the disclaimed assets can pass to the surviving spouse.
 - Potential concerns are (1) that the disclaimer would not be “qualified” because the spouse would own the assets and direct who receives them, and (2) the spouse might be treated as making a gift if the spouse does not disclaim. These concerns and possible responses are discussed at Item 8.h of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.
- An alternate approach is to provide that disclaimed assets would pass to a credit shelter trust.

(10) **State Estate Tax Planning Issues.** For clients that may be subject to state estate taxes, various issues must be considered in addition to the planning considerations described above.

- **State Exemption Amounts.** Seventeen states plus the District of Columbia have a state estate or inheritance tax. Various states are scheduled to adjust their state exemptions to the amount of the federal estate tax exclusion amount (Hawaii, Maine, and Washington, D.C. in 2018, Maryland in 2019, and Connecticut in 2020). New York will move its exemption amount to \$5 million (indexed) in 2019 (to match what the federal basic exclusion amount would have been under pre-Act law). States may not have contemplated an \$11.2 million basic exclusion amount, however, in adopting those provisions, and some states may back off from increasing their state exemptions to the federal basic exclusion amount. See Ashlea Ebeling, *Where Not to Die in 2018*, Forbes (Dec. 21, 2017). When the federal exclusion amount reverts back to \$5 million (indexed) after 2025, those state exemptions would adjust back to that amount as well.

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- **Formula State Exemption Bypass Trust, Balance Outright to Spouse.** Because disclaimers sometimes don't happen as a practical matter, the clients may want to mandate that the bypass trust will be funded with the state exemption amount at the first spouse's death.
 - **QTIP Trust Planning.** For clients subject to a state estate tax, flexible QTIP trust planning could result in (i) a "standard" QTIP trust for the excess over the federal basic exclusion amount, (ii) a QTIP trust effective only for state purposes (sometimes referred to as a "gap trust") for the amount in excess of the state exemption amount but less than the federal exclusion amount if the state allows a "state-only QTIP election," and (iii) a Clayton QTIP that has expanded into broader terms for up to the state exemption amount. This has the advantage of effectively having a federal bypass trust for an amount up to the full federal exclusion amount, but there is an obvious loss of distribution flexibility since all of the net income of a QTIP trust must be distributed annually to the surviving spouse, although the amount of net income that must be distributed could be managed, to a large degree, by the asset selection for the trust.
 - **Formula State Exemption Bypass Trust, Balance to QTIP Trust.** Some states (like New York and New Jersey) provide that the federal QTIP election (or nonelection) is binding for state estate tax purposes as well. Leaving the balance above the state exemption amount to a QTIP trust would have the advantage of using trust planning for non-tax purposes for all of the estate at the first spouse's death.
- h. **Emphasis on Flexibility.** In light of the remaining inherent uncertainty regarding whether the basic exclusion amount will be reduced back to \$5 million (indexed) after 2025, building in flexibility to trust arrangements will be important, particularly for estates in the \$5-\$22 million range. Provisions included in trusts to avoid estate taxes may be unnecessary (and not desirable) for settlors or beneficiaries who have no estate tax concerns. Some of the ways of adding considerable flexibility are:
- using nontaxable powers of appointment;
 - providing broad distribution standards by independent trustees;
 - granting substitution powers to the settlor; and
 - providing special modification powers to trust protectors (see Item 3(h)(8)-(11) of the Current Developments and Hot Topics Summary (November 2017) found [here](#) and available at www.Bessemer.com/advisor for a more detailed discussion of powers and limitations that can be added for trust protectors to provide flexibility).
- i. **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 exclusion will continue to be important to permit a basis adjustment at the beneficiary's death without generating any added estate tax. Indeed, incorporating planning for the flexibility to cause estate inclusion is more important than estate tax planning for most clients because most clients will not owe estate

tax. The following summary lists a few ideas for basis adjustment planning. For a more detailed discussion of these and various other ideas, see Item 5 of this summary, below.

(1) **Basis Adjustment for Settlor.**

- A very flexible alternative to cause estate inclusion for the trust settlor would be to give an independent party the authority to grant a power to the settlor that would cause estate inclusion, such as a testamentary limited power of appointment, which would cause estate inclusion under §2038 and result in a basis adjustment under §1014(b)(9). (But the IRS might conceivably argue that the settlor is deemed to hold the power under a §2036 regulation even if the limited power is not actually granted to the settlor. See Item 5.e.1 below.)
- The settlor might purchase assets from a grantor trust or exercise a substitution power to reacquire low basis assets that would receive a basis adjustment at the settlor's death.

(2) **Basis Adjustment for Beneficiary.** Possible strategies to allow a basis adjustment at a trust beneficiary's death 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 nontaxable power of appointment);
- to have someone grant a general power of appointment to the beneficiary that possibly could be exercisable only with the consent of some other non-adverse party (but not the grantor); however, the IRS might conceivably argue that it is a power exercisable "in conjunction with another person," making it a general power under §2041(b)(1)(C) even though never granted, see Item 5.f.(4) below;
- to use a formula general power of appointment;
- to the extent that general powers of appointment are used for basis adjustment purposes, bear in mind that the existence of the general power may have creditor effects, but the actual exercise of a testamentary general power of appointment may be more likely to subject the assets to the decedent-beneficiary's creditors than if the general power is not exercised; or
- to trigger the Delaware tax trap by the exercise of a nontaxable power of appointment to appoint the assets into a trust of which a beneficiary has a presently exercisable general power of appointment.

(3) **Upstream Gifts.** Many parents of clients (or other individuals) will have no federal estate tax concerns, even if the parents live past 2025 when the exclusion amount returns to \$5 million (indexed). Gifts may be made to individuals who have no estate tax concerns in hopes of getting a basis increase at the individual's death, and taking steps to avoid §1014(e) in case the donor should die within one year of the

gift. A GRAT may be used to make upstream transfers without requiring a significant taxable gift by the client.

- j. **Transfer and Freeze Planning.** Transfer and freeze planning can (i) assist in shifting wealth to save estate tax for clients with assets in excess of the basic exclusion amount, (ii) provide creditor protection planning, (iii) assist in moving assets downstream during life, which is becoming more important as people have longer life expectancies and inheritances are long-delayed, and (iv) provide income shifting by transferring wealth to family members who may be in lower income tax brackets. The most obvious non-tax advantage of making gifts is to allow donees to enjoy the gift assets currently.

(1) **Window of Opportunity.** The gift tax exclusion amount will sunset back to about \$5.5 million in 2026 (unless changed by Congress prior to 2026). Gifts making use of the doubled gift tax exclusion amount are available for eight years through 2025.

Gifts utilizing the \$11 million exclusion amount can reduce federal estate tax if the donor dies after the basic exclusion amount has been reduced to \$5 million (indexed), assuming clawback does not apply. As an extremely unrealistic example to illustrate the point, a couple with \$20 million of assets may have about \$10 million of assets subject to estate taxes if they die after the exclusion amount has been reduced to \$5 million (ignoring indexing of the exclusion amounts), resulting in \$4 million of estate tax. The \$4 million of estate tax could be avoided entirely by making \$20 million of gifts utilizing each of the spouses' \$10 million (indexed) gift tax exclusion amounts. (Of course, in that circumstance, the grantor would want to take steps to be potential recipient of at least some portion of the transferred amounts, as explored in Item 13.j.(6)-(8) below.)

To take advantage of the window of opportunity, in case the exclusion amount is later decreased, the donor must make a gift in excess of the \$5 million indexed amount. For example, if a donor who has not previously made a taxable gift makes a gift of \$5 million, and if the donor dies after the exclusion amount has been reduced to \$5 million (indexed), the donor effectively will be treated as having used the \$5 million of the exclusion amount, and the donor will not have made any use of the extra \$5 million (indexed) of exclusion amount available in 2018-2025.

(2) **Cushion Effect.** Perhaps the most important advantage of the increased gift tax exclusion amount for many individuals will be the "cushion" effect – the ability to make gifts in excess of \$5 million, but considerably less than \$11 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even for assets whose values are very uncertain). Clients who have been reluctant to implement transfer planning strategies in the past because of fear of the possible assessment of a current gift tax will be much more comfortable making transfers with the cushion effect of the \$11 million gift tax exclusion amount.

(3) **Significance of Defined Value Transfers.** Because of the substantial cushion effect of the very large gift tax exclusion amount, clients making transfers significantly less than the full exclusion amount will have much less incentive to add

the complexity of defined value transfers to gift transactions. However, clients wanting to use most of the \$10 million (indexed) exclusion amount will likely plan to use a defined value transfer to minimize the risk of having to pay gift tax. For a discussion of defined value clauses, see Item 14 of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at www.Bessemer.com/Advisor.

(4) **Specific Gift Opportunities.**

- Gifts to dynasty trust to utilize \$10 million (indexed) GST exemption (or making a late allocation of GST exemption to previously created trusts if the donor does not want to make further gifts);
- Forgiveness of outstanding loans to children;
- Gifts to grantor trusts, and leveraging grantor trusts with loans or sales from the grantor;
- Equalizing gifts to children or grandchildren;
- Gifts to save state estate taxes (very few states treat gifts as reducing estate exemption amounts, even for gifts made within three years of death in gross estates);
- GRATs (GRATs will continue to be advantageous even with the \$10 million (indexed) gift tax exclusion amount);
- Life insurance transfers (including the ability to “roll out” of split dollar arrangements);
- Deemed §2519 transfers from QTIP trusts (for an outstanding detailed discussion of planning by a surviving spouse with QTIP trusts, see Read Moore, Neil Kawashima & Joy Miyasaki, Estate Planning for QTIP Trust Assets, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 ¶ 1202.3 (2010)); and
- Nonqualified disclaimers (depending on state law treatment of disclaimers).

These specific gift strategies are discussed in more detail in Item 5.o-aa of the 2012 Heckerling Musings and Other Current Developments Summary found [here](#) and available at www.Bessemer.com/advisor.

(5) **Trust Sales.** For mega-wealthy clients, trust sales can be magnified on (super steroids) using the increased gift tax exclusion amount. Using a rule of thumb of having 10% equity to support a sale to a trust, spouses could fund grantor trusts with \$22 million of assets and sell nine times that, or almost \$200 million of assets to the trusts in return for notes bearing interest at the AFR (although the IRS may question if that interest rate is sufficient).

For a pre-existing sale to grantor trust transactions, additional gifts could be made to the trust if needed to bolster the equity value of the trust (and to reduce the

necessity of relying on guarantees) to support the bona fides of the sale transaction, and to reduce the risk of a §2036 attack against the grantor's retained interest via the note from the trust. In several recent cases, the IRS has taken the position that §2036 applies to sales to grantor trust transactions. For some previously completed sales transactions, gift to trusts may be sufficient to repay the notes entirely (or the notes could be forgiven) to remove any §2036 risk, at least if the repayment/forgiveness occurs at least three years prior to the grantor's death. Avoiding the risk of a protracted audit and litigation over the §2036 issue could be a significant perceived advantage.

See Item 8.f and Item 11 of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at www.Bessemer.com/Advisor for a more detailed discussion of sales to grantor trusts.

(6) Transfers with Possible Continued Benefit for Grantor or Grantor's Spouse.

Couples with \$22 million of gift tax exclusion amount may significantly reduce their potential estate tax liability by making gifts to utilize the increased exclusion amount, particularly if either or both spouses die after 2025 when the estate exclusion amount is scheduled to decline to \$5 million (indexed). But the couples making such large transfers will likely want some kind of potential access to or potential cash flow from the transferred funds.

Planning alternatives for providing some benefit or continued payments to the grantor and/or the grantor's spouse include:

- Spousal limited access trust ("SLAT") and/or exercise by beneficiaries of nontaxable powers of appointment (discussed in more detail in Item 3.j.(7) below);
- "Non-reciprocal" trusts;
- Self-settled trusts established in asset protection jurisdictions (and the more conservative approach may be to allow a third party to appoint assets to the settlor under a non-fiduciary power of appointment rather than including the settlor as a discretionary beneficiary under fiduciary standards);
- Transferring residence to trust or co-tenancies between grantor/spouse of grantor and trust;
- Preferred partnership freeze;
- Payment of management fees to the grantor;
- Inter vivos QTIPable trust; and
- Retained income gift trust.

Possible alternatives that do not shift value to the transferor but at least provide possible cash flow or a way to access specific trust assets include:

- Borrowing of trust funds by grantor;

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- Sale for a note or annuity rather than making a gift of the full amount to be transferred, resulting in continued cash flow to the transferor; and
 - “Reverse grantor trust” transaction in which the donor purchases (including through the exercise of a substitution power) or borrows assets gifted to trust.

Each of these alternatives is discussed in more detail in Items 14-24 of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at www.Bessemer.com.

(7) **SLATs.** One spouse funds an irrevocable discretionary “spousal lifetime access trust” (SLAT) for the other spouse and perhaps descendants. Assets in the trust avoid estate inclusion in the donor’s estate if the donor’s estate is large enough to have estate tax concerns. Both spouses may create “non-reciprocal” trusts that have sufficient differences to avoid the reciprocal trust doctrine. Assets are available for the settlor-client’s spouse (and possibly even for the settlor-client if the spouse predeceased the client) in a manner that is excluded from the estate for federal and state estate tax purposes.

Could the donee-spouse exercise a power of appointment to leave the assets into a trust with the original donor-spouse as a potential discretionary beneficiary if the donee-spouse predeceases without causing estate inclusion under §§2036 or 2038? The issue under §2036 is whether the IRS could establish the existence of an implied agreement that the donor would become a beneficiary if the donee-spouse predeceases. Under §2038, retention is not required at the time of the original transfer, and the donee-spouse must be careful not to give the donor-spouse anything that would rise to the level of a right to alter, amend, revoke, or terminate. For example, the donor-spouse could not have a testamentary power of appointment by reason of the exercise.

Another important issue if the original settlor should become a discretionary beneficiary if the spouse predeceases is whether the settlor’s creditors could reach the trust assets under applicable state law. Some possibility exists that the trust may be treated as a “self-settled trust” and subject to claims of the donor’s creditors under what has been called the “relation back doctrine.” The creditor issue could be avoided if DAPT laws apply to the trust or if state spendthrift trust law specifically protects against the settlor’s creditors in the “surviving settlor” scenario. A number of states have such statutes for QTIP trusts, and some states have extended that coverage to other trusts as well. *E.g.*, TEX. PROP. CODE §§112.035(d)(2) (settlor becomes beneficiary under exercise of power of appointment by a third party), 112.035(g)(1) (marital trust after death of settlor’s spouse), 112.035(g)(2) (any irrevocable trust after death of settlor’s spouse), 112.035(g)(3) (reciprocal trusts for spouses). Accordingly, even couples in non-DAPT states may nevertheless be able to transfer substantial assets (up to \$22 million using reciprocal/non-reciprocal trusts) to trusts that may benefit one of the spouses that may be protected from the creditor claims of both spouses.

In addition to avoiding estate inclusion, the trust also provides protection against creditors, elder financial abuse, and identity theft. Over time, the trust can accumulate to significant values (because it is a grantor trust, the client will pay income taxes on the trust income out of other assets) and can provide a source of funding for retirement years. (As with any inter-spousal transfers, clients should be aware of potential implications of the transfers on divorce.)

To maximize the creditor protection feature of SLATS (i) the trustee should have the ability to sprinkle distributions among various beneficiaries, (ii) at least one independent trustee should consent to distributions, (iii) any named trust protector should be someone other than the settlor, and (iv) the trustee should be authorized to permit beneficiaries to use assets (rather than having to make distributions for them to enjoy benefits of the trust).

If a non-grantor trust SLAT is desired for income tax savings features (obtaining multiple SALT deductions, §199A deductions, etc.), an ING-type arrangement would be needed. See Item 3.o below.

For a detailed discussion of SLATs and “non-reciprocal” SLATs, including a discussion of the §§2036 and 2038 issues and creditor issues, see Items 16-17 of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

(8) **Section 2519 Deemed Transfer.** A type of transfer that offers the ability to take advantage of the increased \$10 million (indexed) gift exclusion amount in the event that the exclusion amount later sunsets back to \$5 million (indexed) while still leaving cash flow for a surviving spouse who is the beneficiary of a QTIP trust is to make a §2519 transfer. The surviving spouse could make a gift or release a small portion of the income interest (say 1%), and be treated as making a gift of the entire remainder interest under §2519. 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. Even though the deemed gift of the remainder interest is not added back into the tentative estate tax base as an “adjusted taxable gift” in the estate tax calculation, the amount of gift tax that would have been payable (using the date of death rates and the date of death exclusion amount if regulations clarify that clawback does not apply) “with respect to gifts made by the decedent after December 31, 1976” is still subtracted from the estate tax calculation. §2001(b)(2). The effect is that the date of gift value portion of the amount of the remainder interest that is included in the gross estate under §2036 is offset by the “gift tax payable” subtraction with respect to that amount, so only the net appreciation is effectively subjected to estate tax– thus making use of the gift exclusion amount that was available at the time of the gift. 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.)

If the QTIP trust is larger than the gift that the spouse wants to make, the QTIP trust can be divided into two separate QTIP trusts under state law, and the §2519 deemed transfer could be made from only one of the severed trusts. See PLR 20171006.

(9) **Transfers to Non-grantor Trusts.** Some transfer planning may entail transfers to non-grantor trusts for income tax savings reasons. See Item 3.o below.

(10) **Upstream Gifts or Other Gifts to Moderate Wealth Individuals; §1014(e).** Many parents of clients will have no federal estate tax concerns, even if the parents live past 2025 when the exclusion amount returns to \$5 million (indexed). While the gift tax exclusion amount is \$10 million (indexed), 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 under §1014(e) 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. For a detailed discussion of this planning alternative, see Item 7.c of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at www.Bessemer.com/advisor.

If the client wants to use an upstream transfer but does not want to use the client's gift tax exclusion amount in doing so, a GRAT could be used with the remainder interest passing to an upstream trust for the client's parents.

Similarly, gifts may be made to other individuals who have no estate tax concerns in hopes of getting a basis increase at the individual's death, and taking steps to avoid §1014(e) in case the donor should die within one year of the gift (for example, by having the assets pass into a discretionary trust for the original donor's benefit rather than passing outright to the original donor, *cf.* PLR 90036036). For a detailed discussion of planning issues surrounding §1014(e), see Item 8.c of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at www.Bessemer.com/advisor.

(11) **Be Very Careful Before Making Lifetime Gifts of Low Basis Assets.** The estate tax savings of gifts 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%) – if the estate tax is not repealed – 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 state income taxes also apply on the capital gains.

(12) **Report Transactions on Gift Tax Returns With Adequate Disclosure.** Many planners encourage clients to file gift tax returns to report gift or non-gift transactions to start the statute of limitations. Otherwise, the possibility of owing gift tax on an old transaction is always present. The historic rate for auditing gift tax returns is about 1%, and this rate has not been rising in recent years (although more gift tax returns may be reviewed in the future as the number of taxable estates decreases).

In order to start the statute of limitations, the return must meet the adequate disclosure requirements of Reg. §301-6501(c)-1(f). *See e.g.*, LAFA (Legal Advice Issued by Field Attorneys) 20172801F (requirements not satisfied but no details of what disclosure was lacking); Field Attorney Advice 20152201F (no adequate disclosure where (i) partnerships were not identified correctly, (ii) one digit was left off each partnership's taxpayer identification number, (iii) the description said that the land owned by the partnership was appraised by a certified appraiser, but the appraisal was not attached and the appraisal did not value the partnership interests, and (iv) the description summarily stated that "Discounts of __% were taken for minority interests, lack of marketability, etc., to obtain a fair market value of the gift"); PLR 201523003 (adequate disclosure can foreclose later attacks on issues other than valuation such as whether a split gift election was properly made). These rulings are reminders that the IRS looks for opportunities to take a second look at returns, often years later in an estate tax audit. Err on the side of very complete and thorough disclosure on the 709.

For a detailed discussion of the background and planning issues around the adequate disclosure rules see Item 20 of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at www.Bessemer.com/Advisor.

(13) **Emphasis on Flexibility.** Flexibility will continue to be a focus point for planning.

- **Limited Powers of Appointment.** Liberal uses of limited powers of appointment provide flexibility. Turney Berry has stated "We sprinkle powers of appointment like pixie dust."
- **Broad Discretion Over Distributions.** Allowing broad discretionary distributions of trust assets to a broad class of beneficiaries by an independent trustee adds flexibility. Even more flexible is a limited power of appointment that could be exercised in a non-fiduciary capacity.
- **Substitution Powers.** Use non-fiduciary substitution powers to cause grantor trust status (which also yields great flexibility for the donor to purchase favored or low-basis assets from the trust) and include provisions authorizing someone other than the donor to remove the substitution power. This will be balanced against a desire in some situations of using non-grantor trusts, to utilize the exemptions and thresholds available for purposes of the state and local taxes deduction (with its \$10,000 limit per taxpayer) and the §199A deduction (with its exceptions applicable for taxpayers with income below \$157,500 (\$315,000 for joint returns)(indexed).

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- **Trust Protectors.** Consider giving an independent person (sometimes referred to as a “trust protector”) broad flexibility to modify the trust based on changes in tax laws or if the donor’s “net worth drops below a certain level that is unforeseen and independently significant.” Alan Gassman, Christopher Denicolo, Kenneth Crotty & Brandon Ketron, *The Reversible Exempt Asset Protection (“REAP”) Trust for 2017 Planning*, LEIMBERG ESTATE PLANNING NEWSLETTER #2500 (January 11, 2017) (hereinafter “Gassman et al, “REAP Trust”).
 - **Trust Protector Causing Inclusion in Grantor’s Estate.** The trust could also give a trust protector (with the limitations described above) the power to grant a power to the donor that would cause inclusion in the grantor’s gross estate (such as a limited power of appointment, which would cause estate inclusion under §2038 if the estate tax is not repealed). See Martin Shenkman & Jonathan Blattmachr, *Not So Hard to Figure: The Critical Importance of Current Continuous Estate Planning*, LEIMBERG ESTATE PLANNING NEWSLETTER #2491 (Dec. 19, 2016). Possible caveats, however, are discussed at Item 5.e.(1) below.
 - **Trust Protector Adding Donor as Beneficiary; DAPT States.** Considering giving a trust protector the ability to add the donor as a discretionary beneficiary if the trust is established under the laws of a domestic asset protection trust state “if described conditions are satisfied, such as the donor’s net worth dropping below a certain level, if the federal estate tax is repealed, or the protector determines that the estate tax is no longer a concern to the donor’s family.” *Id.* The grantor might include himself or herself as a discretionary beneficiary of the trust from the outset if the grantor resides in a self-settled trust (DAPT) state, though being a possible appointee under a non-fiduciary power of appointment may be a more conservative alternative. If the grantor lives in another state and attempts to apply the laws of a DAPT state, the laws of the domicile state may nevertheless apply under the “strong public policy” exception from being governed by the choice of law provision in the trust agreement. In addition, a debate is ongoing about comment 2 under §4 of the Uniform Voidable Transactions Act (formerly the Uniform Fraudulent Transfer Act), which may cause a transfer by a person from one state that has no legislation regarding self-settled trusts to a trust governed by the laws of a DAPT state as being voidable *per se*.
 - **Limitation on Trust Protector Powers.** The “REAP Trust” article suggests including various limitations on the trust protector and protector powers:
 - Use a committee of at least three trust protectors (trusted individual or financial institutions) with appropriate checks and balances in place between them;
 - Provide a mechanism for the succession and possible replacement of trust protectors;
 - The donor should not have the power to remove and replace any of the trust protectors or exercise any of their powers;

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- Trust protector powers should not be conditioned on approval of the donor or any individual related or subordinate to the donor;
The trust protector powers should be exercisable only in their sole and absolute discretion. Gassman et al, "REAP Trust."
- k. **Avoiding 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 may want 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). For various planning strategies, see Item 6.c of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at www.Bessemer.com/Advisor.
- l. **Revised Charitable Planning Paradigms.** Because no necessity would exist for an estate tax charitable deduction if the estate tax will not apply because of the increased basic exclusion amount, a new paradigm would apply to charitable dispositions at death for decedents with assets under the increased basic exclusion amount who are likely to die before sunseting occurs in 2026.
- In a family with unified goals about charitable transfers, consider making bequests to individual family members and allowing them to make lifetime gifts to the same desired charities, giving the individuals an income tax deduction. Alternatively, the desired amount of charitable bequest could be funded out of mandatory annual distributions from a trust over various years, structured so that the §642(c) charitable deduction would offset taxable income of the trust.
 - Charitable bequests to trusts would no longer have to be in the form of a qualified interest. Assets could be left to a trust providing that all income would be paid to charity, which would allow the trust to receive a §642(c) income tax deduction, thus, reducing the trust's DNI to zero, meaning that trust distributions to others would not carry out income to them.
- m. **State Tax Planning; Domicile.** State estate and income tax planning will continue to be important. Domicile planning (to eliminate or reduce contacts with high-tax states) can be significant to minimize state taxes and may be especially important in light of the Act's limiting the SALT deduction to only \$10,000 per year.
- n. **Selection of Entity and Business Restructuring.** The Act raises new factors in the selection of entity decision for businesses and may lead to business restructuring efforts to make maximum use of the new §199A deduction for qualified business income. These issues include whether the entity should be structured as a C corporation (to take advantage of the lower tax rate on current income, but realizing that a subsequent dividend tax applies as dividends are withdrawn by shareholders), and whether a business in a "specified service" industry taxed as a pass-through entity should be divided so that a separate firm would provide ancillary administrative

support (such as secretarial services, accounting, document management, information technology support, etc.) that would charge the “specified service” company for its support services, hoping that the business income of the support entity would qualify for the §199A deduction. See Avi-Yonah, Batchelder, Fleming, Gamage, Glogower, Hemel, Kamin, Kane, Kysar, Miller, Shanske, Shaviro, & Viswanathan, *The Games They Will Play: An Update on the Conference Committee Tax Bill* (December 22, 2017) (excellent discussion of specific strategies including “cracking” and “packing” strategies for specified service companies).

A common issue for real estate owners as well as other owners of multiple investment vehicles is that owners often have the various investments in separate entities owned by a holding company, and the holding company or a separate management company provides operational services for the various entities. Each separate business is considered separately for purposes of the §199A deduction, but each separate business does not have wages (because all of the services are provided by the holding company or management company). Perhaps a management agreement with each separate entity could be structured so that each entity bears a portion of the wages paid to employees. Cf. *Lender Management LLC et al. v. Commissioner*, T.C. Memo. 2017-246 (LLC providing investment management and financial planning services to various other family entities in return for profits interest entitled to §162 deductions for expenses as a trade or business).

- o. **Non-Grantor Trusts for Income Tax Savings; Multiple Trusts.** The increased gift tax exclusion amount may afford the practical ability for some clients to fund non-grantor trusts for income shifting purposes and for other income tax reasons. The non-grantor trusts may be helpful for various purposes, including (i) to take advantage of the separate \$10,000 SALT deduction limit that would be available to each trust, (ii) to have separate taxpayers with qualified business income that are below the \$157,500 taxable income threshold to qualify for the exceptions to the wage limitation and specified service company rules for the §199A deduction, (iii) to make deductible charitable contributions (if the client could not otherwise use charitable deductions because of the standard deduction), (iv) to take advantage of the qualified small business stock 100% gain exclusion for up to \$10 million of gains (see Item 19.b below), and (v) for state income tax savings purposes. The separate trusts should have different primary beneficiaries because the trusts would be subject to the anti-abuse provisions for multiple trusts under §643(f) for trusts having substantially the same grantors and primary beneficiaries if the principal purpose of the trusts is to avoid income tax. However, §643(f) applies “under regulations prescribed by the Secretary” and no such regulations have ever been issued. In *SIH Partners v. Commissioner*, 150 T.C. No. 3 (January 18, 2018), the Tax Court addressed the validity of regulations that were adopted in response to §956(d) referring to a tax effect for controlled foreign corporations that would apply “under regulations prescribed by the Secretary” and §956(e) providing that “[t]he Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section” In that case the taxpayer “contends, and respondent does not dispute” that §956(d) “is not self-executing” and that the amount of income inclusions at issue “can be determined only by reference to regulations....”

To the extent that the grantor wished to be a discretionary beneficiary of the trust, the general structure of an ING-type trust could be used (except it would be a completed gift trust), or a SLAT could be structured with ING-type provisions. *E.g.*, IRS Letter Rulings 201744006-008 (examples of the many rulings that have addressed “DING” trusts).

The separate non-grantor trusts may result in substantial income tax savings in some situations. The tax savings from estate planning structuring often occurs years in the future; this is a way that planners could structure trusts in some situations that would result in immediate tax savings to offset the legal expense of the estate planning services.

- p. **Undoing Prior Planning.** If the estate tax had been repealed, some clients may have wanted to undo prior planning that was implemented to avoid the estate tax. That will be less significant in light of the fact that the doubling of the basic exclusion amount only lasts eight years. See Item 6.I of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and Item 6 of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at www.Bessemer.com/Advisor for a discussion of possible issues about undoing prior planning.)
- q. **Partnerships with Preferred Partnership Interests.** A donor may create a partnership and retain the right to a preferred return (in a manner that complies with §2701) and give to an irrevocable trust the common interest that has the right to excess return and appreciation. The preferred return may end up being much of the income produced by the partnership; in effect the donor is making a gift of future appreciation (to the extent the partnership grows above the preferred return) but *gets to keep much (if not all) of the income* produced by the partnership. Only the preferred interest is included in the estate (plus cumulative payments on the preferred interest that have not been consumed). See *Estate of Boykin v. Commissioner*, 53 T.C. Memo 297 (1987) (decendent gave voting common stock and retained nonvoting preferred stock; IRS argued that the gifted voting stock was included in the gross estate under §2036(a)(1) because the decendent retained “nearly all the income from the transferred property”; court disagreed because the “only rights decendent retained were those accorded to the ... nonvoting shares he retained, which were separate and distinct rights from the rights enjoyed by the voting shares that he transferred”). See also *Hutchens Non-Marital Trust v. Commissioner*, 66 T.C. Memo 1993-600 (1993) (interest that the decendent held in his family-owned corporation prior to recapitalization was not includible in his gross estate under §2036 because the decendent received adequate consideration for the pre-recapitalization stock, the decendent retained no interest in stock surrendered in the recapitalization, and the decendent’s post-recapitalization control and dividend rights came from new and different forms of preferred stock that he received in the recapitalization).

Alternatively, a noncumulative preferred interest (that does not comply with §2701) could be retained and the common stock could be given. The preferred stock would

have a zero value, and the client would need enough gift exemption to cover the common stock. If the estate tax is not repealed at the client's death, the full value of the preferred stock (presumably its liquidation value at par) would be included in the gross estate (resulting in a basis step), but in calculating the estate tax, the use of the unified credit caused by valuing the preferred at zero would be restored under Reg. §25.2701-5(a)(3). The noncumulative retained preferred interest permits some flexibility in the cash flow that will actually be paid to the client (although substantial compliance with the partnership agreement is preferable to avoid potential gift or §2036 consequences.) See Michael N. Goen & Tracy A. Snow, *Tasty Freeze: Preferred Partnership Tax Recipe*, 42 ESTATE PLANNING 5 (May 2015) and Christopher Pegg and Nicole Seymour, *Rethinking I.R.C. § 2701 in the Era of Large Gift Tax Exemptions*, 87 FL. BAR J. 9 (Nov. 2013). See Item 10.c of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor for an example by Ellen Harrison of this planning alternative.

Using preferred partnerships is a sophisticated strategy requiring customized provision in the partnership agreement and requiring a special appraisal of the preferred and common. [Lou Harrison (Chicago, Illinois): "These are good, but I will use GRATs 99% of the time."]

- r. **Testamentary Discount Planning Not As Important.** Even before the estate tax is repealed, planning to produce valuation discounts at an individual's death has diminishing savings. The estate tax may be lower, but the basis will also be lower, resulting in higher income taxes at some point when the beneficiary ultimately sells the assets (or sooner if the assets can be depreciated). With a 40% estate tax and a 23.8% income tax on capital gains (or higher if the state has a state income tax), the savings may be fairly low. For estates that have assets below the estate tax exclusion amount, discount planning can actually be disadvantageous in reducing the amount of basis adjustment under §1014. See Item 5.d below for a discussion of ways to avoid discounts.
- s. **Many Planning Issues beyond Federal Estate Tax Planning.** Remember all the many things that estate planners do beyond planning for the federal estate tax. 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.

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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) basic 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.

All of these issues (and various other non-tax issues) would still be important for clients.

- t. **Keep Perspective.** Michael Graham (Dallas, Texas) reminds planners of the importance of estate planning beyond saving estate taxes, pointing out that planners assist broadly in the “transporting” of capital from one generation to the next.

Michael observes:

I continue to maintain that not a single less person will die needing at least a Will, not a single less person will have, or be married to, children from a prior marriage. There will continue to be children of great promise and children faced with great challenges. The fact that my lovely wife June would not need to worry about the marital deduction any more doesn't mean she would give everything outright to me at her death. She knows me too well after 47 years of marriage.

Even now, the truth is that for most of our planning, divorce is more likely than death. I did an Ethics presentation for the annual NAELA meeting this year on representing H and W. The statistics are that 70% of second marriages in which there are children from a prior marriage will end in divorce within 5.5 years. Think about that. Even now, we are drafting in anticipation of divorce, not death.

We are not the railroad unless we treat ourselves as such. We are transportation. We assist in transporting capital from one generation to the next.

4. Treasury-IRS Priority Guidance Plan and Miscellaneous Guidance From IRS

- a. **Overview of IRS Priority Guidance Plan.** Four new items were added on the Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015.

“1. Guidance on qualified contingencies of charitable remainder annuity trusts under §664.

...

3. Guidance on basis of grantor trust assets at death under §1014.

...

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.”

Items 3, 5, and 8 all relate to sales to grantor trusts, suggesting that issues related to sales to grantor trusts are major “radar screen” issues for the IRS. These issues are discussed further in Items 4.b, 4.c, 4.d, and 4.e of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at www.Bessemer.com/Advisor.

The 2016-2017 Priority Guidance Plan was published August 15, 2016 included two new items dealing with (1) spousal support trusts under §682 (whether references to income are to taxable income or fiduciary accounting income) , and (2) irregularities in the administration of split interest trusts.

The 2016-2017 Plan deleted two GST items that had been on the plan for a number of years (including the allocation of GST exemption at the end of an ETIP, and extensions of time to make GST exemption allocations).

A focus of the Trump administration is cutting down on the burden of regulations and reducing complexity and taxpayer burden. The Trump administration placed a temporary freeze on regulations projects in an executive order signed January 20 (which is typical for a new administration). The Administration on January 30, 2017 also signed an executive order establishing a “one-in, two-out” system for regulations, requiring that for each new regulation, agencies must find at least two to repeal in order to reduce the net regulatory costs. The Treasury is still working with the Office of Management and Budget (OMB) to address how that order applies to transfer tax regulations.

Executive Order 13789, issued on April 21, 2017, directed Treasury to review all “significant tax regulations” issued on or after January 1, 2016, and Notice 2017-38 identified eight proposed, temporary and final regulations that may impose an undue financial burden on taxpayers or add undue complexity to the tax laws; the §2704 proposed regulations were included in that list of eight. The IRS published its Second Report on October 2, 2017 that, among other things, recommended withdrawing the §2704 proposed regulations (with rather startling harsh language including a reference to the proposed regulations as applying “fanciful assumptions”). The §2704 proposed regulations were formally withdrawn on October 17, 2017. REG-163113-02, FR Doc. 2017-22776, filed 10/17/2017 for publication 10/20/17.

The Treasury issued its 2017-2018 Priority Guidance Plan on October 20, 2017, in a somewhat different format than prior years to conform to the directions of Executive Order 13789. It lists only projects that the Treasury hopes to complete prior to June 30, 2018.

- Part 1 addresses the eight regulations identified in the Notice 2017-18, and among other things includes the withdrawal of the §2704 proposed regulations (and those proposed regulations have now been formally withdrawn).
- Part 2 describes certain projects “identified as burden reducing” and includes the basis consistency regulations, final regulations under §2642(g) regarding extensions of time to make GST exemption allocations, and guidance under §301.9100 regarding relief for late regulatory elections.
- Part 3 deals with partnership audit regulations.
- Part 4 is similar to prior years’ plans. The “Gifts and Estates and Trusts” section includes only three items:
 - “1. Guidance on basis of grantor trust assets at death under §1014.
 2. Final regulations under §2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011.
 3. Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.”

Dana Trier, deputy assistant secretary for tax policy, has added that the Treasury department “is also looking at some 200 rules identified as outdated....The true number was closer to 300, but 200 was chosen as a more conservative number in an October 2 department report, he said.” John Herzfeld, *Treasury Officials a ‘Bridge’ in Tax Reform*, BNA DAILY TAX REPORT (October 24, 2017).

On February 7, 2018, the IRS issued a second-quarter update to the 2017-2018 Priority Guidance Plan that adds a new Part 1 titled “Initial Implementation of Tax Cuts and Jobs Act (TCJA)” and renumbers each of the remaining Parts of the Plan that was published on October 20, 2017. (Did the IRS not notice that the “TCJA” name was removed from the 2017 tax legislation?) Part 1 lists 18 projects that are

“near term priorities as a result of the Tax Cuts and Jobs Act legislation;” several of particular interest are:

7. Computational, definitional, and anti-avoidance guidance under new §199A.
10. Guidance on computation of unrelated business taxable income for separate trades or businesses under new §512(a)(6).
16. Guidance on computation of estate and gift taxes to reflect changes in the basic exclusion amount.

Government officials announced at the ABA Tax Section meeting on February 9 that Treasury and the IRS aim to release the projects added to the 2017-2018 Priority Guidance Plan before July, 2018, observing that they were selective about the projects that needed to be completed first.

Item 16 is rather surprising. Is that referring to the directions to provide regulations to address the clawback situation (which would not become operative for 8 years and would not seem to be a “near term priority”) or does it refer to something broader than that?

Item 10 is a topic that has been very concerning to exempt organizations. Under the 2017 Tax Act, UBTI must be determined for each trade or business activity. (See Item 2.f.(1) above.) An organization may invest in a variety of fund of funds and each of them may have hundreds of portfolio companies. Does the organization somehow have to trace down to each the activity of each separate company? Or for a debt-financed portfolio, is each separate security in the portfolio treated as a separate activity? See Robert Lee, *New Business Income Guidelines Baffle Tax-Exempt Groups*, BNA DAILY TAX REPORT (Feb. 7, 2018).

New §512(a)(6) provides that the unrelated business taxable income (including for purposes of determining any NOL deduction) is determined separately for each trade or business activity. A loss from one activity cannot offset the income from another activity in determining the organization’s UBTI, but a loss from an activity in one year can offset the income from the same activity in another year. Under a special transition rule, NOLs that arise in taxable years beginning before 2018 that are carried over to a later year are not subject to this new limitation.

As a practical matter, though, the IRS’s resources for regulatory projects will be focused for the next year (or more) on essential regulations implementing a variety of provisions in the 2017 Tax Act (including, among many others, the §199A deduction for qualified business income from passthrough entities).

Treasury Deputy Assistant Secretary for Tax Policy Dana Trier has confirmed that big-picture policy calls regarding guidance under the 2017 Tax Act are being made in consultation with the Senate Finance Committee, the House Ways and Means Committee, and Treasury Secretary Mnuchin. Senate Finance Committee Chairman Orrin Hatch had stated that he plans to pressure the administration to implement the

tax law as Congress intended. See Laura Davison, *Tax Law Rules to Be Shaped by White House, Congress: Treasury*, BNA DAILY TAX REPORT (Feb. 21, 2018).

- b. **Guidance on the Basis of Grantor Trust Assets at Death Under §1014.** This issue first appeared on the No Ruling list in the 2015 Rev. Proc. (June 29, 2015): “whether the assets in a grantor trust receive a section 2014 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....” This No Ruling position continued in the 2016 and 2017 No Ruling Revenue Procedures.

PLR 201544002 (issued one day after the 2015 Rev. Proc. announcing this project) held that assets in a revocable trust created by FOREIGN grantors for their US citizen children would receive a stepped basis under §1014(b)(2). This item first appeared on the Priority Guidance Plan ONE MONTH later with the 2015-2016 Plan (issued July 31, 2015). Planners assumed this item on the Priority Guidance Plan would deal with that narrow foreign trust matter.

Based on comments by IRS representatives at the AICPA National Tax Conference in November, 2017, indications are that the intent is to address broadly when grantor trust assets get a step up in basis. Examples of issues that the project might address reportedly include: assets subject to the grantor’s power of substitution, the treatment of notes given to the grantor in a sale to a grantor trust, self-cancelling installment notes, and elective community property (Alaska, South Dakota, Tennessee) for residents of other states.

- c. **Alternative Valuation Date Regulations.** The “anti-Kohler” re-proposed regulations (portions of Prop. Reg. §§20.2032-1(c) & 20.2032-1(f)) include various examples of transactions that will be prohibited under the regulations to reduce artificially the value of assets during the 6-month alternate valuation period. The examples include a contribution of assets to a limited partnership or the dilution of a decedent’s interest in an entity to a noncontrolling interest are treated as accelerating transactions. Also, multiple distributions or sales of interests during the 6-month period are treated as proportionate distributions without applying a fractionalization discount attributable to the fractionalized interests thereby created.
- d. **Guidance Under §2053 Regarding Personal Guarantees and the Application of Present Value Concepts.** The regulation project will address the deductibility as administration expenses under §2053 personal guarantees of the decedent and may address applying present value concepts to the deductibility of administration expenses (so that only the amount of expenses, discounted to the date of death or perhaps the due date of the estate tax return, could be deducted under §2053). If the proposed regulations adopt that approach, they could restrict or eliminate the deductibility of interest on Graegin notes.
- e. **Closing Letters.** In a June 16, 2015 update to the “Frequently Asked Questions on Estate Taxes” on the IRS website, the IRS indicated 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 change in procedure is made in light of cuts to the IRS budget and in light of the fact that a closing letter does little good for returns filed solely to elect portability (because the statute of limitations on that return for determining the DSUE amount 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 new procedure has been widely criticized by planners. The IRS responded by describing a procedure by which the taxpayer could obtain an account transcript which would serve the purpose of a closing letter. In early December 2015, the IRS added a webpage entitled “Transcripts in Lieu of Estate Tax Closing Letters” describing the process. Notice 2017-12, dated January 23, 2017, provides guidance on the methods available to confirm the closing of an examination of the estate tax return. The notice states that an account transcript with a transaction code of “421” and explanation “Closed examination of tax return” can serve as the functional equivalent of an estate tax closing letter for third persons.

Some practitioners have had great difficulty in becoming qualified to access the IRS transcript system and acquiring the account transcript for an estate. IRS officials are still encouraging practitioners to use the transcript system, however.

- f. **Same-Sex Marriage; Notice 2017-15 Allowing Recovery of Applicable Exclusion Amount and GST Exemption Allocation.** In light of the constitutional findings regarding same-sex marriage in the *U.S. v. Windsor* and *Obergefell v. Hodges* Supreme Court cases, the IRS has issued several rulings addressing the tax effects of same-sex marriage.

Rev. Rul. 2013-17 clarified that for federal tax purposes (1) terms relating to marriage include same-sex couples, (2) a place of celebration standard is applied if a same-sex couple moves to a state that does not recognize same-sex marriages, and (3) the ruling does not apply to domestic partnerships or civil unions.

Notice 2017-15 clarifies that an individual who made a gift to a same-sex spouse that should have qualified for a marital deduction, but for which the statute of limitations has run on obtaining a refund of the gift tax paid, may recalculate the remaining applicable exclusion amount as a result of recognizing the individual’s marriage to his or her spouse. The Notice describes various procedures and limitations.

For further details about these rulings, see Item 5.h of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at www.Bessemer.com/Advisor.

- g. **Relief Procedure for Extension of Time to File Returns to Elect Portability, Rev. Proc. 2017-34.** Section 2010(c)(5)(A) requires that the portability election be made on an estate tax return for the decedent whose unused exclusion amount is being made available to the surviving spouse. Rev. Proc. 2014-18 allowed a relief procedure for certain estates through December 31, 2014 and Rev. Proc. 2017-34 provides a relief procedure through the later of January 2, 2018 or the second anniversary of the decedent’s date of death in certain cases if the estate was not otherwise required to file an estate tax return. See Item 16.d of the Current Developments and Hot Topics

Summary (December 2017) found [here](#) and available at www.Bessemer.com/Advisor.

- h. **Section 6166 Guidance.** The IRS has been working on new comprehensive proposed regulations under §6166. A primary issue is the requirement of security in making a §6166 election, but the existing regulations will be restated and replaced with new regulations.
- i. **GST Trust Modification Rulings Suspended But Now Resumed.** Cathy Hughes (with the Treasury Department) has announced beginning in the fall of 2016 that the IRS temporarily suspended considering GST rulings for trust modifications until further notice. This was not added to the “no-rule” list in Rev. Proc. 2017-3 because it was not a permanent change. The reason for this change was that the IRS does not have sufficient resources to continue considering these requests, which are often accompanied by a huge stack of documents. Requests that were filed before this change of policy were still considered; future submitted requests would be returned.

Government officials have informally indicated (in June 2017) that the temporary suspension of GST trust modification rulings has now been lifted, and the IRS will again entertain these ruling requests.

- j. **Report from Treasury Inspector General For Tax Administration Regarding Estate and Gift Tax Return Examination Process.** The Treasury Inspector General for Tax Administration (TIGTA) released a report on September 26, 2017 titled “Improvements Are Needed in the Estate and Gift Tax Return Examination Process” (Reference Number: 2017-30-081). The report reviewed the audit processing of estate and gift tax returns during Fiscal Year 2016. The report included the following conclusion:

TIGTA’s review of the classification, prioritization, and inventory assignment processes identified improvements that are needed in the Internal Review Manual (IRM) guidance, classification sheet documentation, and managerial oversight. TIGTA found that:

- There is minimal IRM guidance for case classification, prioritization, and inventory assignment processes.
- Some classification sheets, when filled out by classifiers, are difficult to read or are incomplete.
- A single employee prioritizes cases selected for examination during classification sessions and assigns these cases to the field for examination, and a lack of documented managerial reviews over the processes poses risks.

Also, case documentation guidelines were not followed in 18 (47 percent) of 38 randomly sampled estate tax examinations and in 17 (46 percent) of 37 randomly sampled gift tax examinations.

...

TIGTA made several recommendations to improve the examination of estate and gift tax returns, including the creation of a legible classification sheet; revisions to the IRM; strengthening of internal controls; and develop guidance on the circumstances in which it is advisable to propose and issue inconsistent notices of deficiency in estate and gift tax examinations.

In response to the report, IRS officials agreed with the recommendations and plan to take appropriate corrective actions.

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- k. **Administration’s Fiscal Year 2018 and 2019 Budget Proposals.** The administration releases a budget proposal each year (historically in a report titled “General Explanations of the Administration’s Fiscal Year ____ Revenue Proposals” that is often referred to as the “Greenbook”), and during the Obama years, a number of estate and gift tax proposals were included. The budget proposals from the Trump administration have not included specific tax legislation proposals. The FY 2019 budget, titled “An American Budget,” was published February 12, 2018. The Treasury’s Office of Tax Policy has indicated that it will release a full proposal next year after giving officials a chance to evaluate the new tax law.

5. Basis Adjustment Planning

The increase of the estate tax exclusion amount to \$5 million (indexed) under the 2010 Act and to \$10 million (indexed) under the 2017 Tax Act means that almost all of the population will have no estate tax concerns, but will be entitled to basis adjustments to the date of death value under §1014. Some refer to this as “free-basing,” to obtain a “free” basis adjustment without any offsetting estate tax. Basis adjustment planning takes on added significance in light of the greatly enhanced \$10 million (indexed) exclusion amount under the 2017 Tax Act.

- a. **Asset Classes Benefitting the Least and Most From Basis Adjustment.** Assets that receive no benefit from basis adjustment under §1014 include IRD items and IRAs. Assets receiving minimal to moderate benefit from basis adjustment include qualified small business stock (because a 100% exclusion of gain up to a generous limit is available in any event under §1202), and high basis stock. Assets receiving the most benefit include “negative basis” real estate, assets taking bonus depreciation on qualified property under §168(k) (the recapture of 100% upfront expensing is all ordinary income), and creator–owned copyrights, trademarks, patents, and artwork.
- b. **Swap or Purchase of Grantor Trust Assets.** To the extent possible, the grantor should consider swapping high basis assets in return for low basis from the grantor trust (the low basis assets owned by the grantor at death would receive a basis adjustment under §1014). The most conservative is for the settlor to transfer cash, or high basis assets. If the grantor does not have ready cash, consider borrowing cash from a third party lender to use to pay the trust. Following the grantor’s death, the trust could use the cash to repay the grantor’s estate, which could then repay the bank.

If none of those are available, the grantor might consider giving the trust a promissory note in return for low basis assets. The trust’s basis in the note is unclear. In the partnership context, a number of cases have held that a partner who contributes a note to a partnership gets no increased adjusted basis in his or her partnership interest. *E.g., VisionMonitor Software, LLC v. Commissioner*, T.C. Memo. 2014-182. In the corporate context, a shareholder contributed real property encumbered by debt in excess of basis, which would ordinarily result in gain recognition, but the shareholder also contributed a note equal to the excess liabilities, and the court treated the note as having basis to offset the gain recognition. *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1997). (Other corporate cases have

reached a contrary result.) The note given to the grantor trust may have a basis equal to the basis of the property received in return. The result is unclear. Paul Lee makes the following argument to support a theory that the note does have basis:

It can validly be argued that none of the authorities mentioned above are on point. For example, if creditor loans \$1 million to debtor and creditor is deemed to have zero basis in the promissory note, then why is there no income or gain when the creditor is paid back in full or why is the creditor entitled to realize a loss if the debt is not paid back in full? Furthermore, in the installment sale to IDGT context, if the death of the grantor is treated as a sale immediately after the date of death, then a zero basis in the note would be a taxable gain event. Yet, very few practitioners believe that should be the case. As such, there is a clear argument for giving the IDGT a basis in the note equal to the basis in the assets sold. Paul Lee, *Putting It On & Taking It Off: Tax Basis Management Today (For Tomorrow)*, at 44 (2018).

- c. **Sale to Grantor Trust; Avoiding “Crane” Gain From Deemed Transfer of Assets With Liabilities In Excess of Basis.** The IRS may have given up on arguing that a sale recognition event occurs at death if the grantor still holds a note from the grantor trust at death. Chief Counsel Advice 200923024 concluded that converting a trust from nongrantor to grantor trust status was not a taxable event. An interesting statement in the CCA is relevant to the commonly asked question of whether there is gain recognition on remaining note payments at the death of the grantor if the grantor has sold assets to a grantor trust for a note. In addressing the relevance of “Example 5” (Reg. § 1.1001-2(c) Ex. 5), *Madorin*, and Rev. Rul. 77-402, the CCA observed:

“We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner **which is generally not treated as an income tax event.**” (emphasis added)

The IRS has not, however, necessarily given up on making a traditional *Crane* argument that a deemed transfer of assets from the grantor to the trust at the grantor’s death (when the trust becomes a non-grantor trust) with an associated liability (the note from the trust) in excess of basis results in gain under the *Crane* doctrine. Paul Lee suggests that a possible approach to avoid that argument is to create an LLC and have the grantor trust and the grantor each contribute assets. The LLC is a disregarded entity. The LLC owns the assets subject to the note, and also owns the grantor’s note that has been transferred to the LLC. Because the same entity owns both the liability and the associated receivable, the liability disappears. Because this was done in a disregarded entity, no taxable event should result. On the grantor’s death, the LLC is converted to a partnership rather than a disregarded entity, because there is no longer a single member for income tax purposes. The deemed transfer should be treated as an asset purchase and contribution, providing a full basis adjustment.

- d. **Avoiding Valuation Discounts for FLPs.** One approach to avoid valuation discounts for assets and an FLP is to argue that the assets are included in the decedent’s gross estate under §2036(a)(2) under the reasoning of *Powell v. Commissioner*, 148 T.C. No. 18 (2017). See Item 6.e of this summary below.

Another approach is amend the limited partnership agreement to remove transfer restrictions as much as possible, but that probably cannot result in totally eliminating discounts.

A preferable approach is to convert the limited partnership to a general partnership. If the partners are concerned about liability on the underlying assets, the partners could initially transfer their partnership interests to wholly-owned disregarded entity LLC, and then convert the limited partnership to a general partnership. The state law exception under §2704(b)(3)(B) for restrictions imposed by state law would not apply because state law does not restrict a partner from withdrawing from a general partnership. A person has the power to disassociate as a partner from a general partnership at any time (Uniform Partnership Act §602(a)), and upon disassociation, the partnership is required to purchase the person's interest in the partnership for a price that is the greater of liquidation value or the value based on a sale of the entire business as a going concern without that partner (UPA §701(a)-(b)). At a partnership's death, the partnership interest would be stepped up to full value (without discounts) and a §754 election would be made to get a basis adjustment on the inside basis of the partnership assets.

e. **Preserving Basis Adjustment Upon Death of Donor/Settlor.**

(1) **Basis Adjustment for Trust Settlor by Granting Limited Power of Appointment.** A very flexible alternative to cause estate inclusion for the trust settlor would be to give an independent party the authority to grant a power to the settlor that would cause estate inclusion, such as a testamentary limited power of appointment, which would cause estate inclusion under §2038 and result in a basis adjustment under §1014(b)(9).

Does this work? Might the settlor be treated as having such a power even if never granted? The key issue is whether the decedent would be treated as having retained a §2036(a)(2) power to designate persons who could enjoy the property. No prearranged understanding should exist for the grant of such a power to defend against an argument that the decedent indirectly retained the power so that §2036(a)(2) could apply (because that section requires that the power be retained by the decedent at the time of the transfer). Reg. §20.2036-1(b)(3) provides that §2036 applies even if a power is merely exercisable in conjunction with other persons (whether or not adverse) and regardless of whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death. That arguably would apply to the permitted grant to the settlor of a limited power of appointment even if it was never actually granted. See Rev. Rul. 73-21, 1073-1 C.B. 405 (decedent's reserved power to name a successor trustee including himself upon the death, resignation or removal of the trustee triggered inclusion under §2036(a)(2) even though a vacancy had not occurred by the time of the decedent's death); *Estate of Farrel v. U.S.*, 553 F.2d 637 (Ct. Cl. 1977); *but see Estate of Kasch v. Commissioner*, 30 T.C. 102 (1958) (contingent power to determine who enjoys property or the income from property is not subject to §2036(a)(2), based on an interpretation of the predecessor statute in the 1939 Code).

That same provision is not included in the regulations under §2038. See Reg. §20.2038-1(b) (“However, section 2038 is not applicable to a power the exercise of which was subject to a contingency beyond the decedent’s control which did not occur before his death... See, however, section 2036(a)(2) for the inclusion of property in the decedent’s gross estate on account of such a power.”)

The court in *Estate of Skifter v. Commissioner*, 468 F.2d 699 (2d Cir. 1972), addressed a fact scenario in which the decedent had transferred a life insurance policy on his life to his wife who years later left the policy under her will to a trust for her daughter with the decedent as the trustee. The analysis analogized §2042 to §§2036 and 2038, and reasoned, in dictum, that §2036 would not apply because the power over the policy was not “retained by the grantor ... when he transferred it to another” (without addressing the potential application of Reg. §20.2036-1(b)(3)). The court reasoned that §2038 would not apply to a power conferred on the decedent “by someone else long after he had divested himself of all interest in the property subject to the power,” but suggested that §2038 would apply if the power were actually granted to the decedent and if the grant was pursuant to authority “that the decedent created at the time of transfer in someone else and that later devolved upon him before his death.” If the grantor authorized a third party to grant a limited power of appointment to the grantor, and the third party actually granted that power to the grantor, then §2038 would apply under this analysis.

Whether the settlor will be treated as having the power causing inclusion in the gross estate even if the limited power of appointment is never actually granted to the settlor by the third party is not clear. The regulation under §2036 is very broad and potentially applies to the situation, and the discussion in *Skifter* is dicta (because the court addressed a §2042 issue and merely discussed §§2036 & 2038 by analogy).

(2) **Repurchase Appreciated Assets From Grantor Trust.** See Item 5.b. above.

(3) **Donor Use of Property.** The donor uses trust property in some way that would reflect an implied agreement of retained enjoyment to cause estate inclusion under §2036 (such as using property without paying adequate rent). (The court rejected the IRS position, however, that the decedent’s continued occupation of a residence without paying rent following the end of the term of a QPRT required inclusion under §2036(a)(1) where the estate demonstrated an intention to pay rent that had not been completed before the decedent died. *Estate of Riese v. Commissioner*, 2011 T.C. Memo. 60.)

(4) **Move Trust Situs.** If the donor is a discretionary beneficiary of the trust in a domestic asset protection (DAPT) state, move the trust situs to a state that does not have DAPT provisions.

(5) **Sell Loss Assets to Grantor Trust.** Sell loss assets to a grantor trust to avoid a step-down in basis at the grantor’s death (because the loss assets would not be owned by the grantor at death).

f. **Basis Adjustment for Beneficiary.** Possible strategies to allow a basis adjustment at a trust beneficiary’s death include the following.

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

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

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

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

In sum, we find that whether the corpus of the marital trust could be invaded for the purpose of avoiding excessive estate taxation depends on the terms of the trust as set forth in Mr. Tierney’s will [T]he language used by Mr. Tierney is very broad. First, “any need” is indicated. The word “need” is not expressly limited to the comfort, support, maintenance, or welfare of the beneficiary. Also, “need” is not limited by any specific exigency of the beneficiary such as a health, medical, or financial crises. In addition, the will provides that the trust corpus may be used to meet not only a “need” but also a “condition.” ... Moreover, it is remarkable that the phrase “any need or condition” is not limited by the phrase “of the beneficiary.” By its express terms, the corpus of the trust may be used for “any need or condition” perceived by Mrs. Tierney with the approval of the trustee, apparently including a “need or condition” of the corpus of the trust itself. Finally, we believe that the appellees adduced sufficient evidence below that the distribution from the principal of the marital trust was necessary in order to mitigate estate tax consequences upon the death of Mrs. Tierney.

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

If a trustee makes distributions beyond what is authorized in the instrument, the IRS may take the position that it can ignore the distribution. *See Estate of Lillian L. Halpern v. Commissioner*, T.C. Memo. 1995-352 (distributions made from “general

power of appointment marital trust” to descendants while surviving spouse was competent and consented were recognized even though instrument did not authorize the distributions; distributions made after spouse was incompetent and when neither she nor a guardian for her consented were not recognized because the Pennsylvania court would likely have allowed her to set aside those distributions, so those distributed assets were included in the surviving spouse’s gross estate under §2041); *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278 (beneficiary-trustee’s distribution of trust assets to herself contrary to the standards in the trust instrument [and the subsequent sale of those assets for a private annuity] were not excluded from the beneficiary’s gross estate merely because of the presence of ascertainable distribution standards in the trust instrument).

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

(3) **Limitations on “Inappropriate” Exercise of General Power of Appointment.** The following paragraph address various uses of general powers of appointment to cause estate inclusion in a beneficiary’s estate. Possible ways of limiting the broad manner in which a general power of appointment could be exercised are (i) to require the approval of a non-adverse party, and (ii) to limit the exercise to creditors of the powerholder.

(a) **Consent of Non-Adverse Party.** The possibility of requiring the consent of a non-adverse party, which would still result in the power being a general power, Section 2041(b)(1)(C)(ii) provides that a power exercisable “in conjunction with” a non-adverse party is still a general power of appointment. The non-adverse party could even be someone that owes fiduciary duties to the beneficiary. Treas. Reg. §20.2041-3(c)(2), Ex. 3; *Estate of Jones v. Commissioner*, 56 T.C. 35 (1971); *Miller v. U.S.*, 387 F.2d 866 (3rd Cir. 1968).

(b) **Limiting Power to Appoint to Creditors.** As an example, the power of appointment might limit appointees to persons related to the powerholder by blood, marriage or adoption or to any charities of the powerholder or of the powerholder’s estate. See §2041(b)(1); Treas. Reg. §20.2041-3(c)(2).

The effect of a power to appoint to the powerholder’s creditors or to creditors of his estate is unclear. For example, assume that the powerholder owes \$100 to Bob. If the powerholder can appoint assets to his creditors, can he appoint all of the trust assets to Bob or only up to \$100? After he distributes \$100 to Bob, Bob is no longer a creditor. A power to appoint to creditors of the estate is more troubling, because Bob is clearly a creditor of the estate at the powerholder’s death, and subsequent events (such as paying \$100 to Bob) do not change the

fact that as of the date of the powerholder's death, Bob was a creditor of the estate.

The issue is important because planners sometimes draft a general power of appointment as a power to appoint to creditors, thinking that this is the most limited general power possible. If the power is not limited to the extent of a creditor's debt, this type of general power is not limited at all. If the power is limited to the amount of the debt, the general power of appointment might not extend to many assets (though no tax cases have so limited the treatment of a power to appoint to creditors as being a general power of appointment over all of the assets subject to the power).

What is the answer? "Everyone knows the answer—but everyone knows a different answer." For example, a BNA Portfolio takes the position there is no limit on the amount that could be appointed to a creditor, but Professor John Langbein says that the power to appoint to creditors can be exercised in favor of a creditor only up to the amount of the debt to the creditor. When asked if he has authority for his position, he responded "You might as well look for authority that the sun rises in the east. This question is so stupid that everyone knows the answer." When told that a lot of people think the answer is different, Prof. Langbein responded "There are a lot of stupid people."

(4) Independent Party With Power to Grant General Power of Appointment. The trust agreement could give an independent party the power to grant a general power of appointment to the surviving spouse. Advantages of this approach compared to making distributions to the beneficiary are (1) the mechanics may be much easier by merely having the independent party sign a one-page document granting the spouse a general power of appointment rather than distributing and re-titling assets, and (2) the individual may be elderly and have management issues with respect to outright ownership of the assets, or may be susceptible to pressure to make transfers to family members or caregivers. A basis adjustment would result under §1014(b)(9).

One commentator raises the question of whether there is a real difference between a power that is conferred by a third party vs. a power exercisable in conjunction with a third party. See Ronald Aucutt, *When is a Trust a Trust?*, at 17, Printed as part of *It Slices, It Dices, It Makes Julienne Fries: Cutting Edge Estate Planning Tools*, STATE BAR OF TX. 20th ANN. ADV. ESTATE PLANNING STRATEGIES COURSE (2014). This raises the possible IRS argument that the beneficiary may be deemed to hold a general power of appointment even if it is never formally granted by the third party. A possible counterargument is the provision in Reg. §20.2041-3(b) that if a power is exercisable only on the occurrence of an event or contingency that did not in fact take place, it is not a general power of appointment. If the independent party never grants the general power of appointment, arguably that is a contingency that never took place within the meaning of that regulation. Stated differently, if the power is never granted to the beneficiary, is it treated as a power exercisable upon the occurrence of an event which never happened and thus not a general power of appointment under Reg. §20.2041-3(b), or is it a power exercisable "in conjunction with another person," making it a general power under §2041(b)(1)(C) even though never granted?

If there are concerns as to how the power holder might exercise a general power of appointment, it might be limited to an appointment in favor of the power holder's creditors, or it might be exercisable only with the consent of a non-adverse party (that is still a general power of appointment, §2041(b)(1)(C)(ii)). To protect the third party from an argument that the party must continually monitor whether to grant or change powers of appointment, the trust could provide that the third party has no authority to grant a general power of appointment until requested by one of various specified family members to do so. In addition, in light of the fiduciary issues that could arise in granting such a general power of appointment, consider using an extremely broad exculpatory clause for the third party. ("Why didn't you realize that giving a \$5 million general power of appointment to my dad increased the value of the estate for purposes of determining the elective share? You actually caused \$1.6 million to pass to the step-monster.")

The following sample clause is by Ben Pruett (Bessemer Trust, Washington, D.C.):

The trustee of any trust hereunder, other than any trustee who is a beneficiary or otherwise interested in such trust, is authorized, with respect to all or any part of the trust property, in its sole discretion and by an instrument in writing filed with the records of the trust, to create in a beneficiary a testamentary general power of appointment, within the meaning of Section 2041 of the Code (including a power, the exercise of which requires the consent of some person other than the person creating such power or any person with a substantial interest in the trust property that is adverse to the beneficiary's exercise of the power in favor of the beneficiary's estate or creditors) or to eliminate or modify any such power previously created hereunder, or to release the foregoing power in whole or in part.

The settlor intends that the foregoing power be available to the trustee whenever the exercise of such power will or may result in some significant tax or other benefit to the beneficiaries such as, for example, the reduction of aggregate federal and state wealth transfer taxes, or the ability to allocate a beneficiary's unused GST exemption to trust property, or to facilitate an adjustment to the capital gains tax basis of such property.

The trustee shall be under no duty to exercise the foregoing power, to inform any beneficiary or other person of the potential benefit of exercising the power, or to monitor any fact or circumstance to determine whether to exercise such power, regardless of whether, or the extent to which, the trustee may have previously undertaken any such exercise, informing, or monitoring. The settlor's expectation is that each beneficiary will engage in responsible estate planning and will alert the trustee whenever the exercise of such power may be beneficial, but that the final decision rest with the trustee. The Trustee shall incur no liability to any person for its exercise of such power or its refusal or failure to exercise such power, absent willful misconduct proved by clear and convincing evidence in the court with primary jurisdiction over the administration of such trust.

The trustee shall distribute to the beneficiary's estate or directly to the appropriate taxing authority, as the trustee may determine, the amount by which the wealth transfer taxes imposed upon the beneficiary's estate exceed the amount of such taxes that would have been imposed, had the trustee refrained from granting a general power of appointment hereunder.

Any legal expenses, fees, or other expenses incurred by the trustee in connection with the exercise of the power granted hereunder shall be borne by the trust to which the exercise of such power relates.

NOTES:

¹ Treas. Reg. 2041(b)(1)(C)(i) provides that any power of appointment that is exercisable only with the consent of the creator of the power is not a general power of appointment. Therefore, it is important that the person with the power to consent be someone other than the person with the authority to grant the general power.

²This is a strong exculpation provision expressly designed to relieve a trustee of any duty to monitor or determine whether to exercise the power to confer a general power of appointment, and this provision recognizes that imposing any such duty on the trustee would be an unreasonable burden.

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

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 benefit from a basis adjustment under §1014.) The sample clause in Item 5.(f)(4)(b) below refers to and describes “Appreciated Property” in a way that would result in a basis increase under §1014, which necessarily would only include non-IRD appreciated property.

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

Several private letter rulings have concluded that formula general powers of appointment equal to a beneficiary’s remaining estate exclusion less the value of the beneficiary’s other estate assets were effective in causing estate inclusion of the trust assets up to that amount. PLRs 200403094 (“having a value equal to (i) the amount of my wife’s remaining applicable exclusion amount less (ii) the value of my wife’s taxable estate determined by excluding the amount of those assets subject to this power”); 200604028 (“equal to the amount of Husband’s remaining applicable exclusion amount set forth in § 2010 of the Internal Revenue Code (‘Code’) minus the value of Husband’s taxable estate (determined by excluding the amount of those assets subject to this power)”). Those rulings

addressed other issues as well, but the rulings clearly reasoned that the assets were included in the deceased beneficiary's gross estate.

(b) **Sample Formula General Power of Appointment of Amount That Will Not Increase Beneficiary's Estate Tax.** The following sample clause is by Lester Law (Naples, Florida) and Howard Zaritsky (Rapidan, Virginia) from the 2017 Heckerling Institute on Estate Planning.

Spousal Testamentary General Power of Appointment.

I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the Appreciated Assets (as such term is defined hereunder). The fractional share and other terms applicable to the power are as follows:

A. **Fractional Share.** The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death. The denominator of the fraction shall be the value of the Appreciated Assets as of my spouse's death.

B. **Appreciated Assets.** The Appreciated Assets shall mean those assets owned by the By-Pass Trust upon my spouse's death the income tax basis of which may increase (and not decrease) pursuant to Code § 1014(a), if such assets passed from my spouse within the meaning of Code § 1014(b).

C. **How Exercised.** My spouse may exercise the power by appointing the said fractional share of the Appreciated Assets of the By-Pass Trust free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment.

(c) **Acts of Independent Significance.** If the surviving spouse (or other beneficiary) has the power to impact the amount that would be subject to the general power of appointment under the formula, the IRS might argue that the beneficiary has a general power of appointment to that maximum extent. See *Kurz v. Commissioner*, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995). However, *Kurz* makes clear that contingencies that would have independent significant non-tax consequences are to be ignored. Those contingencies prevent the decedent from having realistic unfettered control to access the trust assets.

As to the possibility of a marital or charitable bequest increasing the amount of the general power of appointment under the formula, such bequests would seem to be acts of independent significance. However, to avoid that argument, the formula could refer to an amount "determined for this purpose without regard to any available charitable or marital deduction" as in the sample formula clause in Item 5.(f)(4)(b) above.

For a more detailed discussion of the *Kurz* case and the possible implications for formula general powers of appointment, see Item 7.e of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and available at www.Bessemer.com/Advisor.

(d) **Identifying Specific Assets Subject to General Power of Appointment.** A

power of appointment over part of a trust is probably generally considered as being over some fractional part of trust. As long as the amount of the general power of appointment is determined objectively by a formula, perhaps a third party (such as a trustee) could be given the authority to determine which particular assets would be subject to the general power. (Query whether that would be recognized for tax purposes?) Alternatively, the formula could specify objectively which particular assets are subject to the general power of appointment formula amount.

An example of a clause exercising a power to appointment to trigger the Delaware tax trap could be modified to define the scope of a formula general power of appointment:

The foregoing exercise does not apply to the following assets held by the Trust: (i) cash or cash equivalent accounts (such as savings accounts, certificates of deposit, money market accounts or cash on hand in any brokerage or equivalent accounts); (ii) property that constitutes income in respect of a decedent as described in Code Section 1014(c); (iii) any interest in any Roth IRA accounts or Roth variants of other retirement plans, such as Roth 401(k)s, 403(b)s, 457(b)s, and the like; and (iv) any interest in any property that has a cost basis for federal income tax purposes that is greater than or equal to the fair market value of the property at the time of my death (the "Excluded Assets"). If, after eliminating the Excluded Assets, the inclusion of the value of the other assets in the Trust in my taxable estate for federal estate tax purposes would not increase the federal estate tax and state death taxes payable from all sources by reason of my death, this power of appointment shall apply to all remaining assets of the Trust other than the Excluded Assets (the "Included Assets"). However, in the event that the inclusion of the value of all of the Included Assets in the Trust in my taxable estate for federal estate tax purposes would increase the taxes so payable, the assets of the Trust appointed by this Section 2.3 shall be further limited as follows: The Trustee shall for each of the Included Assets evaluate the ratio of the fair market value at the time of my death to the cost basis immediately prior to my death first (the "Gain Ratio"). The Trustee shall thereafter rank the Included Assets in order of their respective Gain Ratio. The appointment shall apply first to the Included Asset with the largest Gain Ratio, and thereafter in declining order of Gain Ratio to each of the subsequent Included Assets; however, as such point that inclusion of the next in order of the Included Assets would otherwise cause an increase in my estate's federal or state estate tax liability as described above, my appointment pursuant to this Section 2.3 shall be limited to that fraction or percentage of that Included Asset that will not cause any federal or state estate tax liability, and all lower ranked Included Assets shall be excluded from the exercise of this power of appointment.

Mickey Davis & Melissa Willms, *All About That Basis: How Income Taxes Have Reshaped Estate Planning*, ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES (April 2017) (the clause is loosely adapted from Morrow, *The Optimal Basis Increase and Income Tax Efficiency Trust*).

For other examples of formula clauses see Appendices A-C of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and available at www.Bessemer.com/Advisor. For various form suggestions for formula general powers of appointment, see Ed Morrow, *The Optimal Basis Increase and Income Tax Efficiency Trust* (April 2017)(available at <http://dx.doi.org/10.2139/ssrn.2436964>); Lester Law & Howard Zaritsky, *Portability: Lots of Questions, Few Easy Answers*, Heckerling Inst. on Estate Pl. (Fundamentals Program) (2017); Al Golden, *Back to the Future – The Marital Deduction from Before ERTA to After ATRA*, STATE BAR OF TEXAS ADVANCED ESTATE PLANNING COURSE at p.17 (2013); HOWARD ZARITSKY, PRACTICAL ESTATE

PLANNING IN 2011 AND 2012 (various forms and excellent analysis); James Blase, *Drafting Tips That Minimize the Income Tax on Trusts—Part 2*, ESTATE PLANNING (Aug. 2013).

(6) Creditors' Rights Regarding Property Subject to General Power of

Appointment. The mere existence of the authority of someone to create a general power of appointment does not by itself create creditor concerns for the person who might be granted a general power of appointment.

If a beneficiary is actually granted a general power of appointment (either by a third party or by formula at the beneficiary's death), the traditional rule has been that would not by itself allow creditors to reach the assets. However, the beneficiary's creditors could reach the assets if the beneficiary actually *exercised* the general power of appointment (although a 1935 Kentucky case said that creditors could not reach the assets even if the power was exercised as long as it was not exercised in favor of creditors). That traditional rule (dating back to a 1879 Massachusetts case) was the position of the Restatement (Second) of Property (Donative Transfers) (§§13.2, 13.4, 13.5). The Restatement (Third) of Property, however, takes the position that property subject to an *unexercised* general power of appointment can be reached by the power holder's creditors if his or her property or estate cannot satisfy all of the powerholder's creditors. Restatement (Third) of Property (Donative Transfers) §22.3 (2011). Some states (such as California, Michigan, and New York) have specific statutory measures adopting the position of the Third Restatement. The Uniform Trust Code applies the Restatement (Third) position to inter vivos general powers of withdrawal in §505(b)(1) (presumably that would also apply to inter vivos general powers of appointment); it does not address property subject to a testamentary general power of appointment, but refers to the Restatement Second position—suggesting that creditors could not reach property subject to an unexercised testamentary general power of appointment.

Section 502 of the Uniform Power of Appointment Act provides that creditors of the holder of a general power may reach the assets subject to the power to the extent the powerholder's property (if the power is *presently exercisable*) or the powerholder's estate is insufficient. (This wording [and the Comment to §502] suggests that the creditors of a person who holds a *testamentary* general power of appointment would not be able to reach the trust assets until after the powerholder dies.) The Comment to §502 clarifies that the rationale of this position is that a presently exercisable general power of appointment is equivalent to ownership. Whether the powerholder has or has not exercised the power is not relevant to this issue. This is the biggest change from traditional law principles under the Uniform Power of Appointment Act, and this is the provision that states are most likely to consider changing. As discussed above, traditionally the creditors of a powerholder with a testamentary general power could not reach the property unless the powerholder exercised the power, but the uniform act changes that result to allow the creditors of the powerholder to reach the assets and some states may want to change that result. There is an exception in the Act for property subject to Crummey withdrawal rights in §503; upon the lapse, release, or waiver of a withdrawal power,

it is treated as a presently exercisable general power only to the extent that it exceeds the annual exclusion amount.

Creditors of a powerholder of a *nongeneral* power of appointment generally cannot reach the assets subject to the power. §504 of the Act.

A possible solution to keep from making assets subject to a general power of appointment available to the powerholder's creditors is to require the consent of a third person (who would need to be a nonadverse party in order for the power of appointment to cause estate inclusion under §2041). See Bove, *Using the Power of Appointment to Protect Assets—More Power Than You Ever Imagined*, 36 ACTEC L.J. 333, 337-38 (Fall 2010).

Greg Gadarian (Tucson, Arizona) suggests a very interesting planning strategy that exists for lapsed withdrawal powers in two states (Arizona and Michigan) that treat the lapsed powerholder as not being the settlor of the trust for creditor purposes. See ARIZ. REV. STAT. §14-10505(B). A number of states have similar provisions that limit creditors' access to assets over which a power of withdrawal has lapsed to amounts described in §§2041(b)(2), 2514(e), or 2503(b), but Arizona and Michigan apply this protection to the entire amount of the lapsed withdrawal. For example, the trust might give a Trust Protector the authority to grant a withdrawal power over the entire trust assets to a beneficiary; the withdrawal power would lapse 30 days after it is granted. The assets would be included in the powerholder's gross estate (to the extent the lapsed power exceeds the "5 or 5" amount in §2041(b)(2)), and the powerholder would (according to various IRS letter rulings) be treated as the owner of the trust for income tax purposes under §678, but the entire trust would continue to have spendthrift protection. This could be used to cause estate inclusion for a surviving spouse to allow a basis adjustment at his or her death and to cause the trust to be a grantor trust as to the surviving spouse, all without subjecting the trust assets to the spouse's creditors following the lapse of the withdrawal power.

The *possibility* that creditors of the powerholder of a general power of appointment can reach the appointment assets (in light of the uncertainty of the development of state law regarding this issue) is an important factor that planners should consider before creating general powers of appointment. Even if an individual has no creditor concerns, the individual is just one auto accident away from a financial disaster.

(7) Beneficiary Exercise of Limited Power of Appointment to Trigger 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. (That summary includes a discussion of using the Delaware tax trap in states that have abolished their rule against perpetuities. In that situation, a possible strategy suggested by some planners is to provide that the original trust lasts for 1,000 years, but that the power can be exercised to create a trust that could last for 1,000 years after the power is exercised. In this manner, the vesting of the property could be postponed for a period “ascertainable without regard to the date of the creation of the first power.”)

- g. **Achieving Basis Adjustment at First Spouse’s Death Regardless of Which Spouse Dies First; Limitations Under Section 1014(e) If Donee Dies Within One Year.** Alternatives for achieving a basis increase at the first spouse’s death include the following. All of these alternatives are discussed in considerably more detail in Item 8 of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at www.Bessemer.com/Advisor.

(1) **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). 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, South Dakota, 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.

(2) **Joint Trusts.** Some planners have attempted, with varying degrees of success to use joint trusts as a way of achieving a basis increase whichever spouse dies first. E.g. PLR 200101021(denying basis increase because of §1014(e)). The strategy has been refined with an alternative that has been termed the Joint Exempt Step-Up Trust (“JEST”).

(3) **Section 1014(e) Limitation if Donee of Gifted Appreciated Assets Dies Within a Year and the Assets Pass Back to the Donor.** 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). That provision likely does not apply, however, if the assets do not return "to" the donor.

(4) **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, and providing that H retains the right to terminate the trust prior to W's death and have the assets distributed to W. The assets would be includible in H's estate under §2038 if he dies first (because of his power to terminate the trust early), and would be includable in W's estate under §2031 if she dies first (because the assets would be payable to her estate). For a further discussion of the Section 2038 Marital Trust, see Item 8.e of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and available at www.Bessemer.com/Advisor.

- h. **Upstream Gifts.** 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. For a discussion of what Melissa Willms has referred to as the "accidentally perfect grantor trust," see Item 7.2 of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at www.Bessemer.com/Advisor. See Mickey Davis & Melissa Willms, *All About That Basis: How Income Taxes Have Reshaped Estate Planning*, ALI-CLE Planning Techniques for Large Estates (April 2017).

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.

- i. **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).

6. Family Limited Partnership and LLC Planning Developments; *Powell v. Commissioner*

- a. **Overview of §2036 Issues.** 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). About 39 reported cases have arisen.

(1) **Section 2036(a)(1).** The IRS typically argues that assets should be included under §2036(a)(1) as a transfer to the FLP/LLC with an implied agreement of retained enjoyment. The government wins about 2/3 of those cases. (In some of those cases, the FLP/LLC assets have been included in the estate under §2036 even though the decedent had transferred the partnership interests during life (*Harper, Korby*.)

Bona Fide Sale for Full Consideration Defense. Almost every one of these cases that the taxpayer has won was based on the bona fide sale for full consideration exception to §2036. (The two exceptions are *Kelly* and *Mirowski*, which held that no retained enjoyment under §2036(a)(1) applied as to gifts of limited partnership interests.) The key is whether “legitimate and significant nontax reasons” existed for using the entity. Having tax reasons for creating entities is fine, but the test is whether “a” legitimate and significant nontax reason applied as well. For a listing (with case citations) of factors have been recognized in particular situations as constituting such a legitimate nontax reason and see Item 8.g of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at www.Bessemer.com/Advisor.

Agreement of Retained Enjoyment. If the bona fide sale for full consideration exception does not apply, the IRS must still establish an implied agreement of retained enjoyment in the assets that were transferred to the partnership or LLC. For a summary list (with case citations) of factors that suggest an implied agreement retained enjoyment, see Item 8.g of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at www.Bessemer.com/Advisor.

(2) **Section 2036(a)(2).** In a few cases, the IRS has also made a §2036(a)(2) argument, that the decedent has enough control regarding the FLP/LLC to designate who could possess or enjoy the property contributed to the entity. Two cases have applied §2036(a)(2) where the decedent had some interest as a general partner *Strangi* and *Turner*.

As discussed in *Strangi*, §2036(a)(2) applies even if the decedent is just a co-general partner or manager, but as a practical matter, the IRS does not view co-manager situations as critically as if the decedent was the sole manager. Having co-managers also typically helps support the nontax reasons for the partnership or LLC.

The law regarding applying §2036(a)(2) to FLPs and LLCs has been turned on its head in *Powell v. Commissioner*, discussed below.

- b. **Other Issues – §2703 and Indirect Gift.** Other issues that the IRS sometimes raise in audits regarding FLP/LLCs are (1) whether specific restrictions in partnership

agreements should be ignored for tax purposes under §2703 (*Holman* and *Fisher II*) and (2) whether contributions to an FLP/LLC immediately followed by gifts or interests in the entity should be treated as indirect gifts of the underlying assets of the entity (*Holman, Gross, Linton, and Heckerman*).

- c. **Chart of FLP/LLC Discounts.** John Porter has prepared a helpful chart summarizing the discounts that have been recognized in cases involving FLP or LLC interests. See the Appendix of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at www.Bessemer.com/Advisor.
- d. **Section 2036(a)(1) Cases in 2015-2016; *Purdue, Holliday, Beyer*.** *Purdue v. Commissioner*, T.C. Memo. 2015-249, held that §2036(a)(1) did not apply to assets contributed to an LLC, relying on the bona fide sale for full consideration exception and focusing on the management of the consolidated family assets as a legitimate and significant nontax reason for the LLC. The *Purdue* case also ruled that gifts of LLC interests qualified for the gift tax annual exclusion and that interest on “*Graegin* loans” was deductible.

Holliday v. Commissioner, T.C. Memo 2016-51, and *Beyer v. Commissioner*, T.C. Memo. 2016-183, both concluded that §2036(a)(1) did cause estate inclusion of assets contributed to an LLC and FLP, respectively.

For a detailed summary of the *Purdue, Holliday, and Beyer* cases, and a planning checklist for structuring the proper formalities for FLPs and LLCs, see Items 10 and 29 of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at www.Bessemer.com/Advisor.

- e. ***Estate of Powell v. Commissioner* – FLP Assets Includable under §2036(a)(2).**

Overview

Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017) is a “reviewed” Tax Court decision that may be the most important Tax Court case addressing FLPs and LLCs since the *Bongard* case (124 T.C. 95 (2005)) 12 years ago. The Tax Court breaks new ground (1) in extending the application of §2036(a)(2) to decedents owning only limited partnership interests, and (2) in raising the risk of double inclusion of assets under §2036 and a partnership interest under §2033, which may (in the court’s own words) result in “duplicative transfer tax.” (The case was decided on cross motions for summary judgement, and is not an opinion following a trial.)

The facts involve “aggressive deathbed tax planning,” and the fact that the taxpayer lost the case is no surprise. But the court’s extension of the application of §2036(a)(2) and the extensive discussion of possible double inclusion for assets contributed to an FLP or LLC are quite surprising (but whether a majority of the judges would apply the double inclusion analysis is not clear).

The combination of applying §2036(a)(2) even to retained *limited partnership* interests and the risk of “duplicative transfer tax” as to future appreciation in a partnership makes qualification for the bona fide sale for full consideration exception to §§2036 and 2038 especially important. In one respect, this means that *Powell* does not

reflect a significant practical change for planners, because the §2036 exception has been the primary defense for any §2036 claim involving an FLP or LLC.

This case is appealable to the Ninth Circuit Court of Appeals, but is not being appealed.

Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017) (Halpern [Senior Judge], joined by Vasquez, Thornton, Holmes, Gustafson, Morrison, Buch, and Ashford, with Foley and Paris concurring in the result only) (concurring opinion by Lauber, joined by Marvel, Gale, Kerrigan, Nega, and Pugh).

For an excellent discussion of the *Powell* case, see Todd Angkatavanich, James Dougherty & Eric Fisher, *Estate of Powell: Stranger Than Strangi and Partially Fiction*, Tr. & Ests. 30 (Sept. 2017) and Mitchell M. Gans & Jonathan G. Blattmachr, *Family Limited Partnerships and Section 2036: Not Such a Good Fit*, 42 ACTEC L.J. 253 (Winter 2017).

For a detailed discussion of the facts and court analysis in *Powell*, see Item 15.g of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at www.Bessemer.com/Advisor.

Facts

The decedent's son, acting on her behalf under a power of attorney, contributed about \$10 million of cash and marketable securities to a limited partnership (FLP) in return for a 99% limited partnership (LP) interest. Her two sons contributed unsecured notes in return for the 1% general partner (GP) interest. The partnership agreement allowed for the partnership's dissolution with the written consent of all partners. The same day, the son who was the agent under the power of attorney (acting under the power of attorney) transferred the decedent's 99% LP interest to a charitable lead annuity trust (CLAT) paying an annuity to charity for the decedent's life with the remainder passing to the decedent's two sons (the remainder was valued by assuming a 25% discount for lack of control and marketability of the 99% LP interest). (A problem with the transfer to the CLAT was that the power of attorney only authorized gifts to the principal's issue up to the federal gift tax annual exclusion amount. The taxpayer argued that gifts were authorized under the power of attorney under general state case law where the gifts were consistent with the estate plan.)

The decedent died 7 days later. [Counsel has indicated that the decedent was recovering nicely from a broken hip, and the CLAT was planned during that recovery, but the decedent contracted an infection after she had been cleared for a hospital discharge and died shortly thereafter from ensuing sepsis. At the time the FLP was funded and the CLAT was funded, counsel indicates that the serious infection had not yet occurred, the decedent was expected to be discharged from the hospital, and a medical opinion was received reflecting a greater than 50% likelihood of surviving a year.]

The IRS claimed that the \$10 million of assets contributed to the FLP were includible in the decedent's estate (without a discount) under §§2036(a)(1) (retained enjoyment or income), 2036(a)(2) (retained right in conjunction with any person to designate who

could enjoy the property or its income), or 2038 (power to alter, amend, revoke, or terminate the transfer at the decedent's death), or under §2035(a) (transfer of property within three years of death that otherwise would have been included in the estate under §§2036-2038 or 2042) if the transfer to the CLAT was valid. The case indicates that the taxpayer did not contest the application of §2036(a)(2) [counsel has reportedly stated that he did *not* concede that issue], or contest that the bona fide sale for full consideration exception to §2036 was not applicable. The taxpayer argued that §§2036 and 2038 could not apply because the decedent no longer owned the LP interest at her death (despite the fact that the interest had been transferred within 3 years of her death and §2035(a) would then apply).

Counsel has indicated that the parties attempted to settle the case. Even when the taxpayer agreed to settle with no estate discount but not paying gift tax with respect to the CLAT transfer, in making the estate calculation the IRS treated the gift to the CLAT as an adjusted taxable gift that was added back to the tentative tax base (despite the express provision in §2001(b) that "gifts includible in the gross estate" are not treated as adjusted taxable gifts for this purpose). The taxpayer ultimately concluded that it had to file a Tax Court petition in order to get the estate tax calculation error corrected.

Court Analysis

(1) Section 2036(a)(2) Issue

The majority and concurring opinions both agreed that §2036(a)(2) applied (though the concurring opinion did not address the reasoning for applying §2036(a)(2)). The majority opinion reasoned (1) that the decedent, in conjunction with all the other partners, could dissolve the partnership, and (2) that the decedent, through her son as the GP and as her agent, could control the amount and timing of distributions. The opinion adopted the analysis in *Strangi* as to why the "fiduciary duty" analysis in the Supreme Court *Byrum* case does not apply to avoid inclusion under §2036(a)(2) under the facts of this case because any such fiduciary duty is "illusory."

The §2036(a)(2) issue is infrequently addressed by the courts; it has only been applied with any significant analysis in four prior cases (*Kimbell* and *Mirowski* [holding that §2036(a)(2) did not apply], and *Strangi* and *Turner* [holding that §2036(a)(2) did apply]). In both *Strangi* and *Turner*, the decedent was a general partner (or owned a 50% interest in the corporate general partner). *Powell* is the **first case to apply §2036(a)(2) when the decedent merely owned a limited partnership interest**. In this case the decedent owned a 99% LP interest, but the court's analysis drew no distinction between owning a 99% or 1% LP interest; the court reasoned that the LP "in conjunction with" all of the other partners could dissolve the partnership at any time. (Whether the court would have applied §2036(a)(2) had the decedent owned only a small LP interest is not known, but the court's reasoning does not draw any distinction based on the amount of LP interest owned by the decedent.)

Because §2036(a)(2) applied, the court did not address §2036(a)(1) or §2038.

(2) "Double Inclusion" Issue

The majority opinion raised, on its own with no argument or briefing from any party, how §2036 or §2038 operate in conjunction with §2043 ostensibly to avoid double inclusion. The consideration received in return for the contribution to the FLP (i.e. the 99% LP interest) is subtracted under §2043 from the amount included in the gross estate under §2036. In effect, the value of the discount is included under §2036/2043 (i.e., the value of the assets contributed to the FLP minus the value of the 99% LP interest considering lack of control and marketability discounts). The opinion refers to this amount as the “doughnut hole.” In addition, the 99% LP interest itself is included in the gross estate (if the gift is not authorized under the power of attorney) or is included in the gift amount if the gift is recognized, and the court referred to this as the “doughnut.” That analysis avoids double inclusion IF the assets have not appreciated (and because the decedent died only 7 days later, the parties stipulated that the contribution values were also the date of death values). But if the assets have appreciated, footnote 7 of the “majority” opinion acknowledges that “duplicative transfer tax” would apply because the date of death asset value is included in the gross estate under §2036 offset only by the *date of contribution* discounted value of the partnership interest. The date of death value of the LP interest would also be included under §2033, so all of the post-contribution appreciation of the assets would be included under §2036 AND the discounted post-contribution appreciation also would be included under §2033. As a result, more value would be included in the gross estate than if the decedent had never contributed assets to the FLP. (Similarly, footnote 17 acknowledges that a “duplicative reduction” would result if the assets depreciated after being contributed to the FLP.) Whether a court would actually tax the same appreciation multiple times (or whether the IRS would even make that argument), in a case in which the majority’s analysis is applied is (hopefully) doubtful, but the majority opinion did not even hint that the court would refuse to tax the same appreciation twice in that situation.

The concurring opinion (joined by seven judges) reasoned that the inclusion of the partnership assets in the gross estate under §2036 meant that the partnership interest itself was merely an alter ego of those same assets and should not also be included in the gross estate. That approach has been followed by the prior FLP cases in which §2036 was applied, and indeed even in this case the IRS did not argue that the asset value/partnership value should be included under both §2036 and §2033, offset by the partnership value at the date of the contribution. (That argument would have been meaningless in this case [because the date of contribution values and date of death values were the same], but the IRS has not made that argument in *any* other FLP cases even though substantial additional estate tax liability would have resulted in situations involving significant appreciation of partnership assets.)

The opinion leaves uncertainty, particularly as to the double inclusion issue, because the “majority” opinion (that espoused the double inclusion analysis) was joined by only 8 judges (one of whom was Judge Halpern, who is a Senior Judge and not one of the 16 current “regular” Tax Court judges), a concurring opinion (that rejected the double inclusion analysis) was joined by 7 judges, and 2 judges concurred in the majority opinion in result only.

The fact that eight judges adopted the double inclusion analysis may embolden the IRS to take that position in future cases, even though we do not yet know how a majority of the Tax Court judges would rule as to that issue. This raises a risk that contributing assets to an FLP (or for that matter, any entity) may leave a taxpayer in a significantly worse tax position than if the taxpayer merely retains the assets.

(3) **Rejection of Gift to CLAT**

The court concluded that the gift to the CLAT was not valid, and therefore denied the IRS's additional gift tax deficiency and also the addition to the gross estate of additional gift tax on the gift made within three years of death.

Observations

(1) **“Overly Aggressive Deathbed Tax Planning.”** The court's refusal to allow valuation discounts is not surprising. The case involves a number of bad (or at least suspicious) factors:

- Funding of the entity only by the soon-to-be decedent;
- With only cash and marketable securities;
- A mere 7 days before death;
- By the decedent's son acting under a power of attorney;
- With a subsequent transfer to a CLAT and a retained charitable annuity for the life of the apparently soon-to-die donor, resulting in a substantial value shift to the agent and his brother.

That the taxpayer lost the case is not surprising.

(2) **Significant Extension of Application of §2036(a)(2) to Retained Limited Partnership Interests.** The §2036(a)(2) issue is addressed infrequently by the courts; it has been applied with any significant analysis in only four prior cases (*Kimbell* and *Mirowski* [holding that §2036(a)(2) did not apply], and *Strangi* and *Turner* [holding that §2036(a)(2) did apply]). In both *Strangi* and *Turner*, the decedent was a general partner (or owned a 47% interest in the corporate general partner). *Powell* is the **first case to apply §2036(a)(2) when the decedent merely owned a limited partnership interest.** In this case the decedent owned a 99% LP interest, but the court's analysis drew no express distinction between owning a 99% or 1% LP interest (although the distinction from *Byrum*'s limitation on the application of §2036(a)(2) because of fiduciary duties would not be as strong if other significant partnership interests existed, particularly if they were unrelated parties, and any fiduciary duties were not “owed to herself”). The court reasoned that the LP “in conjunction with” all of the other partners could dissolve the partnership at any time. (Whether the court would have applied §2036(a)(2) had the decedent owned only a small LP interest is not known, but the reasoning allowing the ability to dissolve the entity by acting “in conjunction with” other partners would not change based on the amount of LP interest owned by the decedent.)

The net effect is that, under this analysis, §2036 will apply to almost all FLPs/LLCs, whether or not the client retains a general partner or managing member interest, unless the bona fide sale for full consideration exception to §2036 applies.

Furthermore the same reasoning would seem to apply to practically any enterprise or investment involving other parties. For example, interests in C corporations, S corporations, or undivided interests in real estate would be subject to the same reasoning that the decedent could join with the other shareholders/co-owners (perhaps even if unrelated?) and dissolve the entity/co-ownership, with all parties receiving their pro rata share of the assets.

(3) **Bad Facts Make Bad Law.** To a degree, this may be a “bad facts make bad law” case. The court may have stretched to find that §2036(a)(2) applied to avoid estate tax discounts for this deathbed transaction that lacked any non-tax purposes, even though the decedent received only limited partnership interests, because of the difficulty of applying §2036(a)(1) when the decedent did not intend to retain ANY interest in the FLP. A consideration of “sham transaction” or “void partnership” theories may have involved fact issues that would have precluded a summary judgment.

The IRS’s real concern is that the transaction was merely a gimmick to produce discounts and lacked economic substance, but the Tax Court had previously rejected the authority of the IRS to merely disregard transfers to partnerships because of the decedent’s “subjective intentions” as long as the partnership was validly formed and changed relationships between the decedent and his heirs and creditors. *Estate of Strangi v. Commissioner*, 115 T.C. 478, 486-87, *rev’d on other grounds*, 293 F.3d 279 (5th Cir. 2002).

(4) **Increased Significance of Bona Fide Sale for Full Consideration Exception to §2036.** The combination of applying §2036(a)(2) even to retained *limited partnership* interests and the risk of “duplicative transfer tax” as to future appreciation in a partnership makes qualification for the bona fide sale full consideration exception to §§2036 and 2038 especially important. Make sure that a legitimate and significant nontax purpose for creating the FLP/LLC exists to satisfy the bona fide prong of the exception, but also be sure that proper capital accounts are maintained to satisfy the full consideration prong of the exception as interpreted by *Stone, Kimbell* and *Bongard*. See *Estate of Beyer v. Commissioner*, T.C. Memo. 2016-183 (full consideration prong of §2036 exception did not apply because of the failure to maintain proper capital accounts).

In one respect, this means that *Powell* does not reflect a significant practical change for planners, because the §2036 exception has been the primary defense for any §2036 claim involving any FLP or LLC. Almost all of the taxpayer victories against a §2036 claim have been based on the bona fide sale for full consideration exception to §2036. (Several exceptions are *Estate of Kelly v. Commissioner*, T.C. Memo. 2012-73 and *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74, which both refused to apply §2036 to gift transactions that did not qualify for the full consideration exception. In addition, *Kimbell v. U.S.*, 371 F.3d 257, 268 (5th Cir. 2004), refused to apply §2036 to transfers to an LLC without addressing whether the bona fide sale for full consideration exception applied to those transfers.)

(5) **Elimination of Unanimous Partner Approval Requirement for Dissolution.** The partnership agreement in *Powell* “allows for the partnership’s dissolution with

the written consent of all partners.” Would the omission of this explicit requirement of unanimous consent for dissolution in the partnership or LLC agreements provide an argument against applying §2036(a)(2) under *Powell*? That would provide a factual distinction from *Powell*, but the court’s reasoning for applying §2036(a)(2) made no reference whatsoever to the unanimous consent requirement for dissolution in the partnership agreement. The court made reference various times to the decedent’s “ability to dissolve” the partnership in conjunction with her sons, but never made reference to the fact that the partnership could *only* be dissolved with her consent.

If the partnership agreement is silent regarding dissolution, the Revised Uniform Limited Partnership Act provides various events that can cause the dissolution of the limited partnership, one of which is “the affirmative vote or consent of all general partners and of limited partners owning a majority of the rights to receive distributions as limited partners at the time the vote or consent is to be effective.” REV. UNIF. LTD. PTNSHIP. ACT §801(a)(2). If the decedent owns a majority of limited partnership interests, the decedent would have the ability to act with others to dissolve the partnership in any event under the Uniform Act (unless the partnership agreement negated that provision). This same provision is included in the California limited partnership act. CALIF CODE CORPORATIONS §15908.01.

If none of the permitted events that would cause dissolution of the partnership involve action by the limited partner, the argument that the decedent could dissolve the partnership in conjunction with others is more tenuous. For example, under the Revised Uniform Limited Partnership Act, if the partnership agreement does not address limited partnership consent regarding dissolution and if a decedent owned less than a majority of the limited partner interests entitled to distributions, the decedent would have no way to participate in the decision to dissolve the partnership. However, the decedent as a limited partner always could join with all the other partners to amend the partnership agreement and add provisions allowing the dissolution of the partnership. *Id.* at §406(b)(1) (affirmative vote or consent of all partners is required to amend the partnership agreement). If a court were inclined to employ common sense limitations in applying the “in conjunction with” phrase (see paragraph 17 below), the ability to join with other partners in amending the partnership agreement seems more remote than an explicit direct ability to join with others in dissolving the partnership.

Indeed, the court in footnote 4 suggests that the application of §2036(a)(2) might have been avoided by a change in drafting of the partnership agreement. (Footnote 4 includes the following clause: “had NHP’s limited partnership agreement been drafted in a way that prevented the application of sec. 2036(a)(2).”) How that drafting would have been accomplished under the court’s reasoning is not clear. If the agreement had been silent regarding dissolution, the general partner and a majority of the limited partners (which would have included the decedent) could have dissolved the partnership under California law. Perhaps the court was suggesting that the partnership agreement could have provided that the limited partners would have had no input into the decision to dissolve.)

(6) **Avoid Having Decedent's Agent as General Partner.** One of the court's reasons for applying §2036(a)(2) was that the son could make distribution decisions and also owed duties to the decedent under the power of attorney from the decedent, thus she had the ability through her agent to determine the amount and timing of distributions. That argument could be removed by having someone serve as general partner other than the decedent or an agent for the decedent under a power of attorney

(7) **Special Voting Interests to Make Liquidation/Dissolution Decisions.** One planning alternative may be to have a special partnership or member interest that would have the *exclusive* ability to vote on liquidation or dissolution decisions. The first rationale of the court's reasoning under §2036(a)(2) would then no longer apply—the decedent could not participate with anyone in deciding when to dissolve the partnership/LLC. That is not a complete answer to the court's reasoning however; under state law, all of the partners/members presumably could agree to change the underlying formation documents any way they wanted, including the omission of the special voting interest. But having significant factual differences may be important if a court looks for ways to distinguish the *Powell* holding.

(8) **Trust Owners with Independent Trustee.** If all of the partners/members were irrevocable trusts with independent trustees, any dissolution proceeds would pass to the irrevocable trusts, and the decedent could not join with the trustee in making distribution decisions, so the court's "in conjunction with" analysis would no longer give the decedent the ability to designate who could receive the income or property contributed to the partnership/LLC. The decedent's interest could be held in an "incomplete gift" trust (for example if the trust was for the sole benefit of the decedent and the decedent had a testamentary power of appointment), but most clients would likely not be willing to be subject to that inflexibility.

(9) **Transfer All Interests During Life.** Some clients have created FLPs/LLCs with the contemplation that some or most of the limited partner/member interest would be retained until the client died, and valuation discounts would apply to those interests for estate tax purposes. In light of the result in *Powell* suggesting that §2036(a)(2) will always apply unless the bona fide sale for full consideration exception is applicable, clients in the future may consider only contributing to entities an amount for which the client would contemplate eventually giving or selling all of the retained interests (and having the foresight to do so at least three years before death). Appropriate discounts should apply in valuing the gifts or in determining sale prices, and §2036 would not apply to include the entity's assets in the estate (without a discount) under §2036.

(10) **"Claim Victory" and Dissolve FLP/LLC with Prior Successful Transfers.** If a client has previously created an FLP/LLC and has made gifts or sales of interests in the entity to trusts that have experienced substantial appreciation, consider dissolving the entity so that the trusts would own the value apart from the FLP/LLC, thus negating any possible §2036 taint. Value attributable to interests that have been transferred at least three years earlier should not be subject to §2036(a)(1) if no implied agreement of retained enjoyment exists (*see the Jorgenson, Kelly, and Rosen cases*), but §2036(a)(2) might continue to apply to gifts of interests over which

the decedent has a continued ability (in conjunction with others) to determine the amount or timing of distributions.

(11) **Rationale for Estate Inclusion for Basis Adjustment Purposes.** If a decedent dies without estate tax concerns and the estate would like to include the FLP assets in the estate without a discount for basis adjustment purposes, the *Powell* reasoning provides a rationale for including the assets in the estate (at least as to interests retained by the decedent or transferred within the prior three years) as long as the transfer to the partnership did not qualify for the bona fide sale for full consideration exception to §2036.

(12) **Double Inclusion Analysis.** The majority opinion's summary of how §2043 applies in the context of §2036 FLP cases is similar to what Professor Jeffrey Pennell has been telling planners for the last decade. *See e.g.*, Pennell, *Recent Wealth Transfer Developments*, ABA REAL PROP., PROB. & TR. LAW SECTION 14TH ANN. EST. PL. SYMPOSIUM, at 21-23 (2003). Up to this point, however, the IRS and all of the prior §2036 FLP cases have avoided that technical analysis by merely including assets contributed to an FLP in the estate under §2036 and not *also* including the retained partnership interest itself in the estate under §2033. (Indeed, even in this case, the IRS did not argue that the assets should be included under §2036 and that the 99% interest should also be included under §2033 to the extent the transfer under the power of attorney was not valid (because gifts were authorized only up to the annual exclusion amount).)

The IRS has previously ruled that life insurance proceeds received by a partnership should be not includible in the gross estate *both* under §2042 and under §2033 as to the decedent's partnership interest under the reasoning that "unwarranted double taxation" would otherwise result. Rev. Rul. 1983-147 (quoted below). Similarly, the regulations regarding GRATs state that if the GRAT assets are included under §2036, the retained annuity interest payments that are payable after the decedent's death are not also included under §2033 "because they are properly reflected under this section." Reg. §20.2036-1(c)(1)(i).

Dictum. The analysis is not central to the conclusion that §2036(a)(2) applies, and in that respect may be treated as dictum.

Appreciation. The big distinction of applying the §2036/2043 and §2033 inclusion analysis is that future appreciation of assets contributed to the FLP/LLC will result in double taxation. See Paragraph 6 above of the Analysis of the Majority Opinion. More value may be included in the gross estate than if the decedent had never contributed assets to the FLP. That issue was not raised in this case, because the parties stipulated that the date of contribution value and the date of death value (7 days later) were the same. Whether a court would actually tax the same appreciation multiple times (or whether the IRS would even make that argument), in a case in which the majority's analysis is applied is (hopefully) doubtful. For example, in Revenue Ruling 1983-147, the IRS refused to include life insurance proceeds payable to a partnership both as part of a partner's interest in the partnership and under §2042 as a result of incidents of ownership attributed to the decedent as partner of the partnership, because doing so would result in "unwarranted double taxation":

In *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), *acq. in result*, 1959-1 C.B. 4, *aff'd on another issue* 244 F.2d 436 (4th Cir. Cir), *cert denied*, 355 U.S. 827 (1957), a partnership held 10 policies on the decedent's partner's life, at his death.... The court found that the decedent, in his individual capacity, had no incidents of ownership in the policies, and held that the insurance proceeds were not includible in the gross estate under the predecessor to section 2042(2) of the Code. The Service acquiesces in the result of *Estate of Knipp* on the basis that in that case the insurance proceeds were paid to the partnership and inclusion of the proceeds under the predecessor of section 2042 would have resulted in the **unwarranted double taxation** of a substantial portion of the proceeds because the decedent's proportionate share of the proceeds of the policy were included in the value of the decedent's partnership interest. See also section 20.2042-1(c)(6) of the regulations (which adopts a similar rule with regard to life insurance proceeds paid to or for the benefit of a corporation). (Emphasis added)

Judge Counting. Not counting Judge Halpern (who is no longer one of the 16 "regular" Tax Court judges), an equal number of judges (seven) joined the plurality and concurring opinions. Therefore, we do not yet know how a majority of the Tax Court judges would rule regarding the double inclusion issue.

Emboldened IRS? The opinion may embolden the IRS to take urge the double inclusion position in future cases, raising a risk that contributing assets to an FLP (or for that matter, any entity) may leave a taxpayer in a significantly worse tax position than if the taxpayer merely retains the assets.

(13) **Reduced Emphasis on Not Retaining Any Interest as General Partner or Manager.** As a result of concerns raised by the *Strangi* and *Turner* cases applying §2036(a)(2) when the decedent held an interest as general partner or manager, planners have discouraged clients from keeping any interest as a general partner or manager of an FLP or LLC. If a client insists on having some participation in management of the FLP/LLC, planners have encouraged the client to minimize the interest as general partner or manager as much as possible. The importance of eliminating or minimizing management participation by the client may be reduced under *Powell*, to the extent it is interpreted as applying §2036(a)(2) in any event as long as the client continues to hold any limited partnership or member interest in the FLP/LLC. All seventeen of the judges participating in the *Powell* decision agreed that §2036(a)(2) should apply in a situation in which the decedent held NO interest as general partner. One possible approach in light of this result is to emphasize reliance on the bona fide sale for full consideration exception rather than avoiding "strings" that could trigger the application of §2036(a)(2). (However, the transferor's retention of substantial control of the FLP/LLC may color the court's perception of whether a legitimate and significant nontax reason existed for creating the FLP/LLC, depending on the nontax reasons for which the entity is created.)

(14) **Basis Implications.** To the extent that partnership assets are included in a decedent's estate under §2036, the assets should receive a basis adjustment inside the partnership "to reflect the value of the property that was included in ... the estate" even without a §754 election for the partnership. *Hurford Investments No 2, Ltd. v. Commissioner*, Tax Court Docket No. 23017-11 (Order dated April 17, 2017); Letter Ruling 200626003. See Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications*, ¶ II.Q.8.e.iii.(b) at 928 n.3635 (June 2017). Under the majority opinion's analysis, some of the partnership asset value will be included under §2036 (offset by §2043) and some will be included under §2033 (what the majority opinion refers to colloquially as the "donut"). Presumably,

all of that value will result in a basis adjustment of the partnership's inside basis, but as to the portion represented by inclusion under §2033, a §754 election may be necessary.

(15) Prior Cases That Have Limited the Broad Application of the “In Conjunction with” Phrase in §§2036 and 2038. Section 2036(a)(2) was enacted with almost identical “in conjunction with” language as in §2038. Several §2038 cases have limited the application of this provision in determining whether a decedent held a joint power to terminate a trust. For example, a power conferred by state law to revoke or terminate a trust with the consent of all beneficiaries is not taxable. *Helvering v. Helmholtz*, 296 U.S. 93 (1935), *aff'g* 75 F.2d 245 (D.C. Cir. 1934) (reasoning that this power exists under state law in almost all situations, and to hold otherwise would cause all trusts to be taxable). (This exception seems analogous to the power under state law of all partners to agree to amend the partnership agreement or to cause the liquidation of the partnership.) Another example is *Tully Estate v. Commissioner*, 528 F.2d 1401 (Ct. Cl. 1976). In *Tully*, decedent was a 50% shareholder. The corporation and decedent entered into a contract to pay a death benefit to the decedent's widow. Even though the beneficiary designation was irrevocable, the IRS argued that it could be amended for several reasons, including that the decedent and the other 50% shareholder could cause the corporation to agree with the decedent to change the beneficiary. The court's analysis is analogous to the broad extension of §2036(a)(2) to FLPs:

In light of the numerous cases where employee death benefit plans similar to the instant plan were held not includable in the employee's gross estate, we find that Congress did not intend the 'in conjunction' language of section 2038(a)(1) to extend to the mere possibility of bilateral contract modification. Therefore, merely because Tully might have changed the benefit plan 'in conjunction' with T & D and DiNapoli, the death benefits are not forced into Tully's gross estate. 528 F.2d at 1404-05.

A possible distinction of applying the logic of these §2038 cases to the “in conjunction with” language in §2036(a)(2) is that the regulations under §2038 specifically state that a settlor's ability to act in concert with all donees/beneficiaries is not a retained power under §2038, but the analogous provisions in the regulations under §2036 regulations do not include that same statement. See Reg. §§20.2038-1(a)(2) (§2038 does not apply “[i]f the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law”); 20.2036-1(b)(3). However, applying the “in conjunction with” clause in a different manner in those two situations does not seem supportable under any policy rationale.

(16) Summary of §2036 FLP/LLC Cases (14-22, With 2 on Both Sides). Of the various FLP cases that the IRS has chosen to litigate, fourteen have held that at least most of the transfers to an FLP qualified for the bona fide sale exception —

(1) *Church v. United States*, 2000-1 USTC ¶60,369 (W.D. Tex. 2000) (preserve family ranching enterprise, consolidate undivided ranch interests);

(2) *Estate of Eugene Stone v. Commissioner*, T.C. Memo 2003-309 (partnerships to settle family hostilities);

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- (3) *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004), *vacating and rem'g* 244 F. Supp. 2d 700 (N.D. Tex. 2003) (“substantial business and other nontax reasons” including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests);
 - (4) *Bongard v. Commissioner*, 124 T.C. 95 (2005) (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts);
 - (5) *Estate of Schutt v. Commissioner*, T.C. Memo 2005-126 (maintaining buy and hold investment philosophy for family du Pont stock);
 - (6) *Estate of Mirowski v. Commissioner*, T.C. Memo 2008-74 (joint management and keeping a single pool of assets for investment opportunities);
 - (7) *Estate of Miller v. Commissioner*, T.C. Memo 2009-119 (continue investment philosophy and special stock charting methodology);
 - (8) *Keller v. United States*, 2009-2 USTC ¶160,579 (S.D. Tex. 2009) (protect family assets from depletion in divorces);
 - (9) *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 BL 223971 (W.D. Ark. Oct. 2, 2009) (centralized management and prevent dissipation of family “legacy assets”);
 - (10) *Estate of Black v. Commissioner*, 133 T.C. 340 (2009) (maintaining buy and hold investment philosophy for closely held stock);
 - (11) *Estate of Shurtz v. Commissioner*, T.C. Memo 2010-21 (asset protection and management of timberland following gifts of undivided interests);
 - (12) *Estate of Joanne Stone v. Commissioner*, T.C. Memo 2012-48 (desire to have woodland parcels held and managed as a family asset and various other factors mentioned);
 - (13) *Estate of Kelly v. Commissioner*, T.C. Memo 2012-73 (ensuring equal estate distribution, avoiding potential litigation, and achieving effective asset management); and
 - (14) *Estate of Purdue v. Commissioner*, T.C. Memo 2015-249 (centralized management and other factors).

Three cases (*Kelly*, *Mirowski*, and *Kimbell*) held that §2036 did not apply (at least as to some assets) without relying on the bona fide sale for full consideration exception. All of the FLP cases resulting in taxpayer successes against a §2036 attack have relied on the bona fide sale exception to §2036 except *Kelly*, *Mirowski*, and *Kimbell*. *Kelly* relied on the bona fide sale exception to avoid treating the contributions to partnerships as transfers triggering §2036, but reasoned that there was no retained enjoyment under §2036(a)(1) as to gifts of limited partnership interests [that obviously did not qualify for the bona fide sale for full consideration exception]. *Mirowski* similarly relied on the bona fide sale exception with respect to contributions to the partnership, but not as to gifts of partnership interests. *Kimbell* relied on the bona fide sale for full consideration

exception as to transfers to a partnership, but as to other transfers to an LLC, the Fifth Circuit refused to apply §2036 (the particular issue was about §2036(a)(2)) without addressing whether the bona fide sale for full consideration exception applied to those transfers.

Interestingly, six of those fourteen cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the *Miller*, *Joanne Stone*, and *Purdue* cases and authored the Tax Court's opinion in *Bongard*. Judge Chiechi decided both *Stone* and *Mirowski*. (Judge Wherry decided *Schutt*, Judge Halpern decided *Black*, Judge Jacobs decided *Shurtz*, Judge Foley decided *Kelly*, and *Church* and *Kimbell* were federal district court opinions ultimately resolved by the Fifth Circuit. *Keller* and *Murphy* are federal district court cases.)

Including the partial inclusion of FLP assets in *Miller* and *Bongard*, 22 cases have applied §2036 to FLP or LLC situations: *Estate of Schauerhamer v. Commissioner*, T.C. Memo 1997-242, *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000), *Estate of Harper v. Commissioner*, T.C. Memo 2002-121, *Thompson v. Commissioner*, T.C. Memo 2002-246, *aff'd*, 382 F.3d 367 (3d Cir. 2004), *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff'd*, 417 F.3d 468 (5th Cir. 2005), *Estate of Abraham v. Commissioner*, T.C. Memo 2004-39, *Estate of Hillgren v. Commissioner*, T.C. Memo 2004-46, *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005) (as to an LLC but not as to a separate FLP), *Estate of Bigelow v. Commissioner*, T.C. Memo 2005-65, *aff'd*, 503 F.3d 955 (9th Cir. 2007), *Estate of Edna Korby v. Commissioner*, T.C. Memo 2005-102, *aff'd*, 471 F.3d 848 (8th Cir. 2006), *Estate of Austin Korby v. Commissioner*, T.C. Memo 2005-103, *aff'd*, 471 F.3d 848 (8th Cir. 2006), *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115, *Estate of Erickson v. Commissioner*, T.C. Memo 2007-107, *Estate of Gore v. Commissioner*, T.C. Memo 2007-169, *Estate of Rector v. Commissioner*, T.C. Memo 2007-367, *Estate of Hurford v. Commissioner*, T.C. Memo 2008-278, *Estate of Jorgensen v. Commissioner*, T.C. Memo 2009-66, *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011), *Estate of Miller v. Commissioner*, T.C. Memo 2009-119 (as to transfers made 13 days before death but not as to prior transfers), *Estate of Malkin v. Commissioner*, T.C. Memo 2009-212, *Estate of Holliday v. Commissioner*, T.C. Memo 2016-51, *Estate of Beyer v. Commissioner*, T.C. Memo 2016-183, and *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (2017). In addition, the district court applied §2036 in *Kimbell v. United States* but the Fifth Circuit reversed.

7. Exercising Trustee Discretionary Distribution Decisions

This summary is based primarily on presentations and materials by Amy K. Kanyuk (Concorde, New Hampshire).

- a. **Trend Toward Greater Discretion.** Trusts traditionally provided income to the current beneficiary, with all remainder passing to the remainder beneficiary. The current trend is to give trustees much more flexibility regarding distributions. Greater discretion provides very helpful flexibility if beneficiaries are getting along, but creates considerable tension if not. Because discretionary powers affect someone's beneficial interest in the trust, they are the most likely trust provisions to result in

potential conflict. “Beneficiaries are like cats—they are only happy if you’re feeding them.”

- b. **Grantor Intent; Drafting Discretionary Distribution Provisions.** The trustee, above all, must act in accordance with the grantor’s intent. **Keep in mind this over-arching target: The goal of the trustee is not to make the beneficiary happy but to carry out the grantor’s intent.**

If the trust agreement contains no express statement of intent, the trustee may have little guidance in the exercise of discretionary powers.

Planners often give little thought to words used to guide the trustee’s discretion but simply rely upon boilerplate without thoughtfully considering how the provisions will impact a particular family.

Trust agreements often provide no explicit and customized expressions of intent, leaving the trustee to exercise discretionary distribution decisions with no guidance, which can lead to beneficiary claims of abuse of discretion.

No one-size-fits-all in drafting discretionary distribution provisions. The planner must discuss with the client the impact of discretionary powers. The following are examples of potential problem areas.

Residence. Who can occupy the residence and under what terms? Is it an exclusive occupancy? Does the beneficiary pay rent or carrying charges? Who pays for improvements?

Multiple Beneficiaries; Primary Beneficiary. If the trust includes multiple beneficiaries, is one a primary beneficiary? If so, under what conditions can distributions be made to secondary beneficiaries? The duty of impartiality exists for all trusts, but the duty has heightened immediacy when a trust has multiple current beneficiaries. The grantor should understand that disputes (or at least hard feelings) invariably will result from pot trusts with multiple current beneficiaries. Hugh Magill’s Rule About Spray Trusts: “If beneficiaries cannot live together in the same household, they should not live together in the same trust.” *See Brown v. Brown*, 2017 Mo. App. LEXIS 576 (2017) (court on summary judgment rejected claim that distributions to decedent’s wife were excessive; trust had HEMS distributions standard for distributions to wife and children, but mandated that the trustee give primary consideration to the needs of the income beneficiary [the wife] rather than conservation of the estate for remaindermen).

Surviving Spouse as Beneficiary. An alternative is to provide that the surviving spouse is the sole beneficiary and give her a power of appointment to appoint assets to children, rather than including children as direct beneficiaries. If the trust includes multiple beneficiaries, the trustee owes a duty of impartiality to all beneficiaries, and they all have rights to information (and can make the surviving spouse’s life miserable).

Practical Impact of Uncertainty Regarding Grantor’s Intent. If the trustee is uncertain about the grantor’s intent, the trustee will likely be conservative in making distributions. ***Correcting an underpayment is easier than recovering an***

overpayment. The trustee may end up limiting distributions to a person that the grantor intended as the primary beneficiary.

Plenary Discretion Regarding Timing of Distributions. Consider including, in almost all trusts, authority for the trustee to withhold distributions if the trustee believes the delay would be in the beneficiary's best interest. This provides wide discretion to address wide ranging issues, such as substance abuse, creditor issues, a pending divorce, etc. For example, if the trust provides for mandatory distributions at specified ages, consider adding the following clause:

Notwithstanding the above, if the trustee determines, in its sole discretion, that a beneficiary does not have the requisite maturity or financial acumen to manage the assets of his or her trust, or for any other reason that the trustee deems appropriate, then the trustee may retain the assets in trust for the life of the beneficiary or until such earlier time (but no sooner than the ages and in the amounts provided in Paragraphs ... above) as the trustee, in its sole discretion, deems appropriate.

- c. **Abuse of Discretion.** Whether an abuse of discretion occurs depends upon basic fiduciary duties, the trust terms and their proper construction, and the grantor's purposes. An abuse of discretion can result from a trustee (1) acting dishonestly (e.g., accepting a bribe to make distributions), (2) making distributions for a purpose not authorized in the agreement, (3) acting arbitrarily or failing to exercise discretion, or (4) not understanding the terms of the agreement or applicable fiduciary law.

Practical Pointer. The trustee should read the entire trust agreement and prepare an abstract of the major terms. That sounds fundamental, but non-professional trustees rarely do that.

Another Practical Pointer. If a request is made for an unusually large distribution, the potential exists for an abuse of discretion claim at some point. "Everyone is happy until they are not. Trustees should manage risk when making a sizable distribution. Getting consents and ratifications from the current and remainder beneficiaries is most acceptable. The trustee should consider getting consents on the front and when everyone is still getting along." (Statement from litigator William Hennessey, West Palm Beach, Florida)

From Years of Experience. As a young lawyer, the planner drafted with broad flexibility. Following years of experience, the planner now provides as much guidance as possible and prefers having a professional trustee. Discretionary trusts are still preferred, rather than requiring mandatory distributions, but guidance must be given to the trustee. The guidance can be in non-binding precatory language, but it should be sufficient to express the grantor's intent.

- d. **Extrinsic Evidence and Letters of Wishes.** If the trust instrument is clear, the court will look only to that language. If ambiguity exists, the court may review extrinsic evidence.

In *Morse v. Kraft*, the trustee requested the Massachusetts Supreme Judicial Court to rule that a common-law right to decant exists. The court allowed the decanting, in part because a post-contribution affidavit was submitted to the court that the grantor intended the trustees to be able to decant (even though the trust was created 30 years earlier). "That seems like a little bit of a stretch to me, but it makes more sense when you realize the "Kraft" in *Morris v. Kraft* is Robert Kraft, owner of the New

England Patriots. As we all know, things tend to go the Patriots way, especially when it comes to officiating.”

Terms of the Trust. The comment to §103 (18) of the Uniform Trust Code recognizes that the phrase “terms of the trust” is not limited to just the trust agreement, and that oral statements, the situations of the beneficiaries, the purposes of the trust, and rules of construction, all may have a bearing on the trust’s meaning.

Side Letters. Side letters or letters of wishes can provide guidance regarding the grantor’s intent. For example, they may address a sensitive topic that the grantor does not want to include in the trust agreement. Such side letters can present difficulties, however. They may be ambiguous, conflict with the trust agreement, contain information that would be hurtful to beneficiaries, or cause adverse transfer tax consequences (are they tantamount to amending the agreement?). Despite the uncertainties, clients really like them. Planners should make sure the clients understand that they are not binding, not enforceable, and may not be discoverable by beneficiaries.

e. **Ascertainable Standards.**

Mixing Discretion With Ascertainable Standards. Accompanying a health, education, support and maintenance standard with words enlarging the trustee’s discretion may cause the scope of the standard to become uncertain. Coupling a distribution standard with broad discretion can be confusing and lead to conflict because no one knows what it means. Example: “My trustee *shall* distribute to my son so much of the assets as the trustee, in its *sole and absolute discretion*, determines is necessary for my son’s health, support and maintenance.” Does the standard produce a ceiling or a floor for distributions?

Creditor vs. Beneficiary Impact. Both the Restatement (Third) of Trusts (§60) and the Uniform Trust Code (§504) eliminate the distinction between discretionary and support trusts. However, “[e]liminating this distinction affects only the rights of creditors... It does not affect the rights of a beneficiary to compel a distribution. Whether a trustee has a duty in a given situation to make a distribution depends on factors such as the breath of the discretion granted and whether the terms of the trust include a support or other standard.” (Unif. Trust Code §60 cmt.)

Often Unnecessary. Unless a beneficiary is serving as trustee, no tax reason exists for limiting distributions to a health, education, support, and maintenance standard. They are often included in trust agreements by draftsmen as a matter of habit. Using such a standard unnecessarily may make the trustee’s job more difficult. Instead, a trust agreement should provide guidance to the exercise of the trustee’s discretion beyond the use of these terms.

Health. The regulations do not define “health.” The Restatement (Third) of the Trusts sites no cases defining the term “health.” Permissible distributions for health may include emergency medical treatment, psychiatric treatment, psychological treatment, routine healthcare examinations, dental care, eye care, and health insurance premiums. If anything outside normal healthcare expenses is intended, the trust agreement should say so specifically. (Beneficiaries can be creative about health needs – such as a swimming pool for exercise.)

Support and Maintenance. These terms mean the same thing. While the terms do not confer a particularly broad power, they are not limited to the necessities of life. A support and maintenance standard may be coupled with an “accustomed standard of living” modifier, which can be problematic if the trust is too small to permit distributions keeping up with the beneficiary’s accustomed standard of living. Exhausting the trust would likely violate the trustee’s duty of impartiality to remainder beneficiaries.

“Support” may include considering a beneficiary’s spouse and minor children. They do not become trust beneficiaries, but a relevant factors in determining what a beneficiary needs for support.

A support and maintenance standard does not allow distributions designed to enlarge the beneficiary’s estate or allow the beneficiary to make large gifts. That situation often occurs. For example, if the surviving spouse has children by a former marriage, the spouse will want all current living expenses to be paid by the trust so that the spouse can keep all of his or her assets. (In that situation, the legal question becomes whether the trust may (or must) consider the beneficiary’s other resources, as discussed below.)

Education. Clarify the level of education intended, how long the benefits will last (for example, an age limit), whether the payment of living expenses and fees are included, the treatment of expenses incurred between college semesters, and whether private education before college is included. Consider the following form language:

In exercising this discretion, it is the Grantor’s wish (but not direction) that when possible, the Trustee will make distributions directly to the educational provider(s) instead of to the primary beneficiary himself or herself. For purposes of this Paragraph, the costs of the primary beneficiary’s post-secondary education may include, but are not limited to, tuition, fees, room, board, books, supplies and transportation. The Trustee’s determination of what expenses constitute costs of the primary beneficiary’s post-secondary education shall be final and not subject to question by any person interested in the trust estate.

Comfort. No one knows what “comfort” means. Many cases reach conflicting results.

Welfare and Happiness. “Happiness” is a *very* broad term; almost any distribution could be justified. “A distribution for ___ would make me happy.”

Emergencies. “Emergencies” are strictly construed to include only extreme needs, but include things such as injury, illness and economic catastrophe, but may also extend to the general inadequacy of resources and earning capacity.

Best Interest. Agreements sometimes refer to a “best interests” standard. In *Ebling v. Hasken*, 2017 Iowa App. LEXIS 1176 (2017), the trust agreement did not include that language, but the court observed that while an action by a trustee may be contrary to the *wishes* of the beneficiaries, that may not be against the *interests* of the beneficiaries.

f. **Tax Considerations; Support Obligations and Removal Powers.**

Legal Obligations of Support. If the trust agreement permits a beneficiary-trustee to make a distribution to satisfy his or her legal obligation to support another person, the distribution power is a general power of appointment even if distributions are limited to those relating to the health, education, support or maintenance of the beneficiary. Treas. Reg. §§20.2041-1(c)(1) & 25.2514-1(c)(1). Trusts typically include an “Upjohn” provision prohibiting the trustee from making distributions that would satisfy the trustee’s legal obligations of support.

Removal and Replacement of Trustee. If a trustee holds tax-sensitive powers, and if a beneficiary has the right to remove the trustee and replace the trustee with someone who is not a related or subordinate party to the beneficiary as defined in §672(c), the IRS position is that the beneficiary holds a general power of appointment. Treas. Reg. §§20.2041-1(b)(1) & 25.2514-1(b)(1); Rev. Rul. 95-58, 1995-2 C.B. 191.

- g. **Scope of Discretion; “Sole and Absolute Discretion.”** Even if a trust agreement grants the trustee “sole and absolute” discretion without an ascertainable standard, the trustee must still act honestly and in the state of mind contemplated by the grantor. The Uniform Trust Code requires that a trustee with the extended discretion exercise its discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

Some planners prefer the flexibility offered by “skinny trusts” merely providing that property shall be distributed to the beneficiaries in the trustee’s sole discretion. Diana Zeydel suggests that “saying less rather than more leads to the greatest flexibility. In some respects, skinny is good.”

- h. **Court Intervention.** A trustee’s exercise of discretion is always subject to judicial review, but courts are often hesitant to review a challenge of the manner in which a trustee exercises its discretion. A decision by a trustee with “extended discretion” (using terms such as sole, absolute, or sole and absolute) will not be overturned unless the exercise is unreasonable. Intervention is not warranted just because the court would have exercised its discretion differently. Although no range of discretion is ever absolute, the greater the grant of discretion, the broader the range that will be afforded the trustee in exercising this discretion.

A court generally will not instruct a trustee *how* to exercise his discretion, but it may intervene following the exercise of a trustee’s discretion in extreme circumstances.

The Uniform Trust Code imposes a *non-waivable* duty that the trustee always must exercise its discretion in accordance with the terms and purposes of the trust and the interests of the beneficiaries. UNIF. TRUST CODE §105(b).

As a practical matter, though, extended discretion makes obtaining court intervention very difficult even when a trustee makes highly conservative judgments as long as they clearly fall within the grantor’s authorized purposes. RESTATEMENT (THIRD) OF TRUSTS §50 cmt. c.

Abuse of discretion claims frequently involve allegations that a trustee acted unreasonably (i.e., beyond the bounds of reasonable judgment). RESTATEMENT (THIRD)

OF TRUSTS §87 cmt. c. A court may impose a general standard of reasonableness even if the trust agreement does not expressly provide one. A reasonableness standard is rather “mushy” and gives the court the ability to overrule the trustee’s exercise of discretion. Grantors can override a reasonableness standard of review. Form language:

The exercise of any Trustee’s discretionary power shall be final unless such Trustee has acted in bad faith. The Grantor recognizes and intends that an effect of the preceding sentence is to eliminate the application of the reasonableness standard to the Trustee’s exercise (or non-exercise) of this discretion to distribute the property of a fully discretionary trust created hereunder.

i. **Fiduciary Duties When Exercising Discretion.**

Duty to Act. The trustee has an affirmative duty to decide whether or not to exercise discretion. The trustee should consider other distribution requests and how the trustee has responded. The trustees should maintain a record of distribution requests. The trustee should have a prescribed **process** of responding to distribution requests. (See the best practices summarized in Item 7.I below.)

Duty to Be Informed. The beneficiaries are entitled to know what information the trustee used in making discretionary decisions.

Duty of Impartiality. The trustee must consider the interests of all beneficiaries, including both current and remainder beneficiaries. The trustee is not required to treat all beneficiaries equally, but must treat them equitably in light of the terms and purposes of the trust. The trust can instruct the trustee to favor one beneficiary over another, and can even authorize depleting the trust for a beneficiary, leaving nothing for remaindermen. Absent such language, a trustee must exercise its discretion in a way that benefits current beneficiaries without harming the remaindermen. If the duty of impartiality is being waived in the trust instrument, do so very explicitly. “We are hereby waiving the duty of impartiality.”

j. **Outside Resources.** Whether the trustee should or may consider outside resources is a frequently litigated issue, but often is not addressed in trust agreements. The general rule is that the trustee must consider other resources but has some discretion regarding what resources should be considered. RESTATEMENT (THIRD) OF TRUSTS §50 cmt. e. (changing the position taken by the Restatement (Second) of Trusts). Cases are inconsistent, however. This general rule can be overridden in the trust agreement.

If the trustee may or must consider outside resources, the trustee must determine which resources to consider. Other resources typically include the beneficiary’s income and periodic receipts. In addition, they may also include the beneficiary’s personal estate. The Restatement (Third) of Trusts includes the following discussion of what outside resources should be considered.

What other resources are to be considered? Where a trustee is to take a beneficiary’s other resources into account in deciding whether and in what amounts to make discretionary payments to satisfy a standard, those resources normally include the beneficiary’s income and other periodic receipts, such as pension or other annuity payments and court-ordered support payments.

A trustee may have discretion, and perhaps a duty, to take account of the principal of the beneficiary’s personal estate, depending on the terms and purposes of the discretionary power

and other purposes of the trust. The settlor's relationships and objectives with respect to both the beneficiary in question and the trust's other current and remainder beneficiaries are of particular relevance. Also important are any income, estate, and other tax purposes the trust may serve (see Comment g), as well as the liquidity (including marketability and income-tax basis) of the discretionary beneficiary's assets.

RESTATEMENT (THIRD) OF TRUSTS §50, cmt. e(2).

Factors that the trustee may decide to consider include:

- whether an unemployed or underemployed beneficiary is unable or simply unwilling to work;
- whether the beneficiary's spouse has financial resources available to the beneficiary; and
- whether the beneficiary's parents have a legal obligation to support the beneficiary.

If a beneficiary's personal estate is considered, the trustee would need to decide whether to consider non-liquid assets, appreciated property, nonmarketable assets, or equity in the beneficiary's home, as well as other types of assets that are more readily available.

If the trustee is considering outside resources, the trustee must act in a reasonable manner to determine those resources, but typically may rely on the beneficiary's representations and on readily available, minimally intrusive information requested of the beneficiary. This would typically include income tax returns, financial statements, balance sheets and budgets. Reliance on information supplied by the beneficiary is inappropriate, however, when the trustee has reason to suspect that the information supplied is inaccurate or incomplete. RESTATEMENT (THIRD) OF TRUSTS §50, cmt. e(1).

If a beneficiary refuses to supply information, the trustee should not make distributions if the instrument or local law requires considering outside resources. Beneficiaries can be very protective of their personal financial information, however, and may refuse to provide financial information and (without reason) sue the trustee for refusing to make distributions. "Keep in mind – Beneficiaries are like cats and they will bite you for no good reason."

- k. **Pattern of Large Distributions That Eventually Will Exhaust the Trust; Process and Disclosure.** A common situation is that a trust authorizes support distributions, perhaps with an express statement to continue the accustomed standard of living. The trust is not large enough, however, to maintain that level of distributions indefinitely. That situation is a common red flag for an eventual potential claim of abuse of discretion. An important part of the process of analyzing discretionary distributions, especially in that type situation, is to analyze the financial impact of the pattern of distributions over a long period of time. Will the trust be able to generate sufficient liquidity at its projected growth rate with a pattern of large cash distributions? Of primary importance in this type of situation is disclosure to the beneficiaries and advisors of the substantial risk that the trust is incapable of accomplishing its purposes, but emphasizing that the trustee wants to work together with the parties to accomplish the grantor's goals as closely as possible. Annual

disclosures and updating of financial projections to reflect changes in the market as distributions are being made are critical. The trustee should document risks to the trust and make clear that the trustee is making no guarantees. Consider having a family sign a family agreement to the terms of the distribution plan and investment approach. Review the situation each year – do not just continue making the same distributions each year (even though the trust is declining rapidly in value) just because “that’s what we’ve always done.”

- I. **Best Practices.** Best practices regarding the trustee’s exercise of discretion for distributions include the following:
 - adopt policies and procedures;
 - read the trust agreement and letters of wishes;
 - prepare an abstract of the trust terms;
 - if the trust agreement has multiple amendments, create a master document adding amendments in the margin;
 - determine and document the standard, if any, for discretionary distributions;
 - for trusts with multiple beneficiaries, determine whether any beneficiary is “primary;” if so, whether distributions to the primary beneficiary could exhaust the trust (waiving the duty of impartiality), and when discretion might be exercised in favor of other beneficiaries;
 - keep complete, accurate and current records of the trust assets (to the extent practicable, including an estimate of the value of illiquid assets);
 - determine whether and which resources of the beneficiary must be considered, and document the procedure for requesting or otherwise obtaining information about resources;
 - document all beneficiary requests for distributions and the trustee’s responses;
 - document whether any conditions must be satisfied before distributions are permitted; and
 - coordinate the trust’s investment policy with required or anticipated distributions.

8. Uniform Directed Trust Act Paves Way For Creative and Thoughtful Divided Trusteeship

The directed trust concept is not new; a Harvard Law Review article in the 1960s discussed the concept. It has become increasingly popular, with various states now having adopted directed trustee statutes and culminating with the promulgation of the Uniform Directed Trust Act in 2017.

This summary of the Uniform Directed Trust Act (the “Act” as used in Item 8 of this summary) and its various innovations is based on materials by Prof. Robert Sitkoff and Prof. John D. Morley, who served as the Chair and Reporter, respectively, of the drafting committee that prepared the Act.

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- a. **Adoption of Act.** The Act was adopted by the Uniform Law Commission in July, 2017. It provides a host of technical innovations that dramatically improve on existing directed trust statutes, and also provides a guide for drafting directed trusts.
 - b. **Scope; Fundamental Definitions.** The Act applies to a “power of direction.” From that follows the definitions of a “directed trust,” “directed trustee,” and “trust director.”

Power of Direction. A power of direction is “a power over a trust granted to a person by the terms of the trust to the extent the power is exercisable while the person is not serving as a trustee.” §2(5) [references in this Item 8 to a “§” are to sections of the Act, unless otherwise indicated]. Thus, the Act applies very broadly to any powers with respect to a trust held by someone other than a trustee (except to the extent that exclusions apply, as discussed below), including a power over the “investment, management, or distribution of trust property or other matters of trust administration.” The comments to the Act include a non-exclusive but highly detailed list of the kinds of specific powers that could be included.

Directed Trust. A directed trust is “a trust for which the terms of the trust grant a power of direction.” §2(2).

Trust Director. A trust director is “a person that is granted a power of direction by the terms of the trust to the extent the power is exercisable while the person is not serving as a trustee.” §2(9).

Directed Trustee. A directed trustee is “a trustee that is subject to a trust director’s power of direction” §2(3).

- c. **Enabling Approach.** The approach of the Act is to authorize the creation of a directed trust that can specify powers of direction, but the statute does not prescribe any specific default powers. This is the approach of the Delaware statute. Some other statutes (such as the South Dakota statute) provide specified powers to certain types of directors (such as an “investment trust advisor” or a “distribution trust advisor”).
- d. **Further Appropriate Powers.** Unless the trust agreement provides otherwise, a trust director “may exercise any further power appropriate to the exercise or nonexercise of a power of direction granted to the director.” §6(b)(1). This is a type of “necessary and proper” clause, granting additional implied powers as appropriate to carry out a settlor’s intent (such as the power to incur reasonable costs, provide accountings, employ advisors, bring litigation to enforce the powers, etc.).

Litigation. A director probably has the authority under this provision to direct the trustee to sue or to bring a lawsuit directly to enforce some action within the director’s scope of responsibility (for example, with respect to a particular investment). Indeed, the director has all the duties of trustees in similar situations; a trustee would have a duty to bring a claim to enforce rights as long as it is cost efficient (Uniform Trust Code §811), so a director arguably has not only a power but a duty to bring a lawsuit to enforce claims. Bringing a lawsuit in the name of the trustee (the trust itself is not a legal entity) seems rather odd, but is authorized. The trustee may, for various reasons be delighted not to be directly involved in and controlling the litigation.

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- e. **Exclusions.** The powers described below are excluded from being treated as a power of direction. Accordingly, the Act does not apply to the power, and the power holder is not treated as a trust director with fiduciary duties, and the trustee has no oversight responsibility under a willful misconduct standard.
- (1) **Trustee.** By definition, a power held by trustee is not a “power of direction” and the Act would not apply to general trustee powers.
- (2) **Nonfiduciary Powers of Appointment.** A nonfiduciary power of appointment is not treated as a power of direction subject to the Act. §5(b)(1). A rule of construction provides that a power of someone who is not a trustee to distribute trust assets is presumptively a nonfiduciary power of appointment. §5(c).
- (3) **Power to Appoint or Remove a Trustee or Trust Director.** The power to appoint or remove a trustee or trust director is not treated as a power of direction subject to the Act (§5(b)(2)); therefore, that person is not subject to the fiduciary duties of a trust director under the Act.
- (4) **Power of Settlor Over a Revocable Trust.** The power of a settlor to revoke the trust is not a power of direction to the extent of the portion of the trust over which the settlor has the power to revoke. §5(b)(3). Making a settlor subject to fiduciary duties with respect to the revocable trust would be nonsensical.
- (5) **Power of a Beneficiary.** A power held by a beneficiary that affects only “the beneficial interest of ... (A) the beneficiary[,] or (B) another beneficiary represented by the beneficiary [under applicable virtual representation law] with respect to the exercise or nonexercise of the power” is not a power of direction subject to the Act. §2(9).
- (6) **Settlor’s Tax Objectives.** The act excludes “a... power over a trust if... the terms of the trust provide that the power is held in a nonfiduciary capacity... and the power must be held in a nonfiduciary capacity to achieve the settlor’s [federal] tax objectives.” §5(b)(5). Accordingly, a nonfiduciary power of substitution, often used to cause a trust to be a grantor trust, would not be a power of direction under the Act.
- (7) **Medical Professional.** A medical professional who is carrying out some function described in the trust is not excluded from the Act, but the duties section of the Act provides that a trust director who is a medical professional acting in a professional capacity will have no duty or liability under the Act in exercising that power (for example determining a settlor’s mental capacity). §8(b).
- f. **Choice of Law; Prospective Application.** The Act applies to a trust “that has its principal place of administration in this state.” §3(a). Thus, the Act employs the prevailing conflict of laws rules for trusts, keying on the trust’s principal place of administration. The Act further defines the “principal place of administration” as referring to the place of administration designated in a trust if (1) a trustee is located in the designated jurisdiction, (2) a trust director is located in the designated jurisdiction, or (3) at least some of the trust administration occurs in the designated jurisdiction. §3(b).

The Act applies prospectively to trusts administered in an enacting state regardless of whether the trust was in existence on the effective date of the Act, but it applies

only with respect to decisions or actions occurring on or after the effective date. §3(a)(1)-(2).

- g. **Fiduciary Duties of Trust Director.** A trust director has the same fiduciary duties and liability as a trustee under like circumstances. §8 (a). Whatever duties a trustee would have had holding that same power are also held by the trust director. The duties can be varied to the same extent that the duties of a trustee can be varied. §8(a)(2). For example, under most states laws, a fiduciary's duties cannot be reduced below a gross negligence standard.

The act specifically acknowledges the creation of springing powers, in which event the trust director will have no duties until the power is triggered. For example, "a settlor could grant a trust director a power to direct a distribution, but only if the director was requested to do so by a beneficiary. A director holding such a power would not be under a duty to act unless requested to do so by a beneficiary." §8(a)(1) cmt.

- h. **Fiduciary Duties of Directed Trustee.** The most controversial issue addressed by the drafting committee, after "extensive deliberation and debate" (as described in the Comments to §9 of the Act), is the fiduciary obligation of the directed trustee.

(1) **Willful Misconduct Standard for Whether to Follow Directions.** Three general regimes for the directed trustee's level of responsibility have been used.

(i) **Serious Breach of Fiduciary Duty.** The common law standard, as codified in §808(b) of the Uniform Trust Code, is that if a trust confers a power upon someone other than the settlor of a revocable trust to direct certain actions of the trustee, the trustee shall act in accordance with those directions "unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of fiduciary duty that the person holding the power owes to the beneficiaries of the trust." That standard has been very unpopular, and every state that has adopted a directed trust statute (other than states that adopted the full Uniform Trust Code) has done something different.

(ii) **Full Reliance.** Some states, such as Alaska, New Hampshire, Nevada, and South Dakota, have adopted a "no duty, full reliance" approach. That approach is what many settlors want—they want to specify that particular persons are responsible exclusively for specific fiduciary functions. They trust those persons to carry out those functions, and they do not want to pay other persons to oversee those functions. All basic trust functions are subject to fiduciary duties, but are not subject to "cross fiduciary duties." It is a "why can't I say what I want?" approach.

(iii) **Willful Misconduct.** The third option is a very reduced fiduciary obligation approach, such as a willful misconduct standard that is used in the Delaware statute (as well as in Illinois, Texas, and Virginia).

The Act follows the Delaware "willful misconduct" approach. The directed trustee is not liable for taking "reasonable action to comply with a trust director's exercise or nonexercise of a power of the direction," except that "a directed trustee must not comply with a trust director's exercise or nonexercise of a

power of direction... to the extent that by complying the trustee would engage in willful misconduct.” §9(a)-(b).

The committee adopted the willful misconduct standard approach rather than the complete abolition of duty approach for several reasons, expressed in the Comments to §9 of the Act. (i) The willful misconduct approach “is more consistent with traditional fiduciary policy,” preserving a minimum of duty for a trustee to maintain the traditional notion that a trustee is a fiduciary. (ii) The directed trust statute in Delaware with its willful misconduct standard has been popular and “establishes that a directed trust regime that preserves a willful misconduct safeguard is workable and that a total elimination of duty in a directed trustee is unnecessary to satisfy the needs of a directed trust practice.” (iii) The willful misconduct approach may be even more protective than the “no duty” approach if a court were to hold that an implied duty of good faith always exists if a fiduciary duty is not otherwise present.

(2) **Reasonableness Standard for Implementing Direction.** The directed trustee must take reasonable actions to comply and implement the direction. §9(a). **Whether** to implement the direction is subject to a willful misconduct standard, but if the direction does not fail the willful misconduct standard, a reasonableness standard applies in **how** the direction is executed.

(3) **Determining Appropriate Directed Trustee Compensation.** Being a directed trustee is not a “no liability” proposition and the directed trustee’s compensation should be set appropriately. Federal bank regulators are critical of directed trusts by national banks, because they believe they are much riskier than reflected by the typical trustee fee being paid for serving as a directed trustee.

One of the first court cases addressing fees for a directed trustee is *Estate of Zeid*, 2017 IL App (1st) 162463-U (2017), in which the trustee negotiated a flat fee rate of 65 basis points annually, but waived its “miscellaneous, litigation, and closely held asset fees.” The bank-trustee requested information about directed assets (at the request of the surviving spouse so she could decide whether to exercise her rights over the marital trust to compel actions regarding assets that were not productive of income), which the advisor (a son from a prior marriage) refused to provide. The bank became concerned over the advisor’s restructuring of debt between different entities that were part of the special directed assets. The advisor sued the bank to impose a different fee structure and force disgorgement of fees previously taken. The court upheld the negotiated fee as reasonable, pointing to the fact that the directed trustee still had numerous obligations.

(4) **Ability to Seek Court Approval.** The Act specifically authorizes a directed trustee “that has a reasonable doubt about its duty” under the Act to “petition the [court] for instructions.” §9(d).

(5) **Specific Situations.** Interestingly, the drafting committee chose not to provide any guidance as to what constitutes “willful misconduct,” and very little case law exists as to what constitutes willful misconduct. In a special session addressing a variety of case studies, the primary issue that arose repeatedly is whether the trustee’s compliance with the direction in that situation would constitute “willful misconduct,” with the panel frequently concluding that it would be a “close call,”

and that a petition for court instructions would be appropriate. The following is a summary of observations of the panelists.

Investment Concentrations. This is by far the most widely used directed trust situation. The settlor wants to maintain a concentrated investment position and appoints a trust director with responsibility over that particular investment (or perhaps all investments). “If willful misconduct means something different than ordinary negligence, relying on a direction about investment concentrations must be ok.” But situations could exist raising concerns. For example, what if the trust director is the chairman of the board of a company that is struggling mightily, or what if the trustee’s investment department has a strong sell order on the particular stock?

Conflicting Directions. Multiple trust directors may have conflicting views and give conflicting directions to the directed trustee. A petition to the court for instructions or a trustee resignation may be the only alternatives for the directed trustee.

Family Business, Director With Conflict of Interest. A very common situation is for a settlor to name one child as the trust director with respect to a family business owned by the trust. What if trusts for a son and daughter each own 50% of the family business, and the son as trust director directs the trustee to sell one share from the sister’s trust to the son’s trust shortly before the sister’s trust terminates, leave the sister’s trust with a minority interest? The trustee would know that this direction benefits the son to the detriment of the sister. Does that reach the level of willful misconduct? The trustee in this situation should disclose the sale direction to the sister, consider obtaining a release from her, and document that communication. This type of situation highlights the directed trustee’s residual responsibility. Although this type of situation involving a family business is common, planners should anticipate that conflicts eventually will arise.

Opaque Investment Holdings. The trust director may direct the trustee to transfer substantial trust assets to a 100% owned LLC, with the director as the manager of the LLC. What if the trustee gets no information about investments within the LLC? Could the director be engaging in transactions unreasonably benefiting himself (such as receiving distributions, loans, or unreasonable compensation)? The LLC may be making distributions to others who are not trust beneficiaries (i.e., charitable contributions). On the one hand, investing trust assets in an LLC managed by the director is just a method of implementing director control of the investments. The more difficult issue is if the LLC becomes a “black box” to the trust.

LLC as Trust Director. One planner is aware of LLCs being named as trust directors. That seems to be permitted because any “person” can be a director and under the uniform laws a “person” includes entities. This may skirt local laws that generally restrict entities from serving as a trustee unless they comply with trust company regulatory requirements.

Conflict of Interest. Assume a scenario in which one cotrustee (C1) has the exclusive power over the investment of trust property, and C1 directs investment of the bulk of the trust property in a series of fledgling technology startup companies in which C1 is an investor or a member of the Board of Directors or for which C1 provides consulting services. The other cotrustee (C2) is aware of the conflict of interest, that C1 has not undertaken due diligence to support the investments, and

that the investments are not prudent in light of the beneficiary's limited risk tolerance. That scenario likely presents a willful misconduct situation, and a petition for court instructions would be appropriate.

- i. **Information Sharing.** The trust director and directed trustee must communicate with each other. For example, a director with a power to amend would have to inform the trustee of any amendment. A trustee responsible for investments must know what cash distributions will be needed for distributions directed by a trust director.

All trust directors have a duty to give information to directed trustees reasonably related to the powers or duties of the trustee, and vice versa. A trust director "shall provide information to a trustee or another trust director to the extent the information is reasonably related both to: (1) the powers or duties of the director; and (2) the powers or duties of the trustee or other director." §10(a). Section 10(b) imposes a similar duty on a directed trustee to share information with a trust director. These duties include both an affirmative duty to provide information (even if it is not requested) and a responsive duty to reply to requests for information.

A safe harbor is provided for trust directors and trustees who act in reliance on information provided to them as long as the person relying on the information is not engaged in willful misconduct. §10(c)-(d).

The information sharing requirement in the Act applies only between trust directors and directed trustees, and does not extend to beneficiaries. The duty to provide information to beneficiaries is governed by the general trust fiduciary law in the enacting state. Even though the trustee may not be required to report the director's directions before implementing the direction, the trustee may still have a duty to report the transactions in its normal accounting reports for the trust.

- j. **Cross Monitoring.** A concern raised by the requirement to share information is whether, upon receiving information, a duty would arise to advise anyone else (beneficiaries, other trustees or directors) that the person would have made a different decision. The act specifically provides that "a trustee does not have a duty to... monitor a trust director... or... inform or give advice to a similar, beneficiary, trustee, or trust director concerning an instance in which the trustee might have acted differently than the director." §11(a). Section 11(b) provides mirror monitoring relief for a trust director as to the monitoring conduct of a trustee or other trust director.

- k. **Adapting the Subsidiary Rules of Trusteeship For Trust Directors.** Various general administrative rules of trusteeship are applied to the trust director relationship as well.

Jointly held powers of direction are generally exercised by majority vote unless the agreement provides otherwise. §6(b)(2).

Section 16 of the Act applies the general rules for trustees to trust directorships with regard to seven administrative issues: acceptance, bond, reasonable compensation, resignation, removal, and vacancy.

The Act also addresses various litigation issues. The limitation periods that would apply to a trustee in a like position and under similar circumstances also apply to trust directors. In addition, a trust director may utilize defenses arising from a report or accounting given to beneficiaries, regardless whether the report was made by that director. §13.

Trust directors will be entitled to the same defenses in an action for breach of trust as are available to trustees, including: laches or estoppel; consent, release, or ratification by beneficiary; reasonable reliance on the terms of the trust; and reasonable care in ascertaining the happening of an event affecting administration or distribution.

- I. **Bifurcated Cotrustee Responsibilities.** The traditional trust law rule is that cotrustees must use reasonable care to prevent a cotrustee from committing a breach of trust, even if the settlor limits the role or function of one of the cotrustees. The Act incorporates all of the provisions regarding trust directors and directed trustees for cotrustee arrangements in which cotrustees are assigned specific responsibilities. “The terms of a trust may relieve a cotrustee from duty and liability with respect to another cotrustee’s exercise or nonexercise of a power of the other cotrustee to the same extent that in a directed trust a directed trustee is relieved from duty and liability with respect to a trust director’s power of direction under Sections 9 through 11.” §12.

Accordingly, a settlor could assign specific responsibilities to separate cotrustees, and the reasonable action and willful misconduct standards described in the Act would apply with respect to a cotrustee’s exercise or nonexercise of a power of the other cotrustee. The rules regarding information sharing and cross-monitoring would also apply to bifurcated cotrustee responsibilities.

Whether a particular trust agreement adopts the divided cotrustee responsibilities is a matter of construction. The traditional law of co-trusteeship would apply as the default rule, but the terms of the trust can manifest a contrary intent. §12. For example, if the decision of one cotrustee controls over that of another in the event of a disagreement, or if a trust gives one cotrustee investment powers with respect to certain trust property, the protections under the Act would appear to apply. The controlling trustee as to a particular function would be treated like a trust director, and the non-controlling trustee would be treated like a directed trustee.

9. Charitable Planning Observations

- a. **Impact of 2017 Tax Act of Charitable Giving.** The reduction in the individual income tax rates is not expected to have much impact on charitable giving. The charitable community is very concerned, however, about the impact of the doubling of the standard deduction (coupled with removing the personal exemption) on the huge amount of “small” charitable gifts on which many charities rely heavily. The percentage of taxpayers that will itemize is expected to decline from about 30% to about 5%. The charitable community estimates that the loss of any tax benefit for non-itemizers as a result of this change will result in a decrease of charitable gifts of between \$13.1 billion to \$24 billion.

One of the changes in the 2017 Tax Act is to eliminate any deduction for contributions to colleges or universities in order to obtain priority for seating or parking at college or university events. Creative alternatives to avoid that rule have not yet surfaced.

- b. **Non-Grantor Trust for Family Charitable Giving.** For a client that is taking the standard deduction and cannot benefit from charitable deductions, Martin Shenkman (Fort Lee, New Jersey) suggests creating a simple non-grantor trust providing that the trustee can make distributions in its discretion to the client's children or to charities (specific charities could be listed if desired). If the client anticipates making charitable contributions of \$10,000 per year, the trust might be funded with \$250,000, which could be expected to produce \$10,000 of income per year (ordinary income plus capital gains). The trust would be entitled to a §642(c) deduction for charitable distributions made from income. Furthermore, the DNI is determined after taking the §642(c) deduction, so any distributions to children would likely have little (if any) DNI carryout to the children.
- c. **IRA Charitable Rollover; Gifts of Appreciated Property.** Particularly for nonitemizers, donors over age 70½ should consider making their charitable donations with IRA charitable rollovers at least up to the amount of the minimum required distribution. Even though the nonitemizer donor does not get an income tax deduction, the donor at least can avoid recognizing income on the IRS required distributions from the IRA.

Similarly, donors making gifts of appreciated property avoid recognizing capital gains they would have had by selling the property, even if they do not get a charitable income tax deduction.
- d. **Camp Proposals Not Enacted.** On February 26, 2014, Rep. Dave Camp (R-MI), the Chairman of the U.S. House of Representative's Ways & Means Committee, released a discussion draft of a forthcoming "Tax Reform Act of 2014" (the "Draft"). The Draft's broad reforms include major changes regarding charitable deductions. The proposal includes several taxpayer-friendly changes, including the ability to deduct charitable contributions made after the close of the tax year but before the due date of the income tax return for that year (April 15 for calendar year taxpayers). The Draft simplifies the complex percentage limitations by imposing a single 40% of AGI limit for both cash and capital gain contributions to public charities, and a 25% of AGI limit for all contributions to private foundations. Charitable contributions would be deductible only to the extent that they exceed 2% of the donor's AGI, and the deduction for the contribution of appreciated property would generally be limited to the donor's adjusted basis in the property, but certain types of property (including publicly traded stock) would be excepted from that rule. These changes would result in substantial increased revenue; the legislation is drafted, and the proposal could resurface at some point.
- e. **Substantiation Requirements.** A variety of cases in 2017 disallowed charitable deductions because of failures in satisfying the substantiation requirements applicable to individual donors under §170(f)(8). *Barnes v. Commissioner*, T.C. Memo. 2016-12 (travel for church inadequately documented); *Oatman v.*

Commissioner, T.C. Memo. 2017-17 (no contemporaneous written acknowledgment); *Luczaj v. Associates et al. v. Commissioner*, T.C. Memo. 2017-42 (no records or contemporaneous written acknowledgment); *Ohde v. Commissioner*, T.C. Memo. 2017-137 (no substantiation for gifts of more than 20,000 items to Goodwill Industries); *Izen, Jr. v. Commissioner*, 148 T.C. No. 5 (2017) (failure to comply with special contemporaneous written acknowledgment requirement for contribution of qualified vehicle); *RERI Holdings I, LLC v. Commissioner*, 149 T.C. No. 1 (2017) (failure to include basis information for gift of LLC interest).

A major concern of donors is how complex the tax rules are – not only the tax deduction rules but also more importantly the substantiation rules, with their requirements of qualified appraisals, making sure receipts are received timely, and that each receipt is accurate. Making sure that every “i” is dotted and every “t” is crossed to satisfy all of those detailed rules has become overwhelming.

Michele McKinnon (Richmond, Virginia) focuses her practice on charitable planning and representing major donors. She indicates that one of the most difficult parts of her practice is making sure a donor has everything the donor needs in order to claim a deduction under the substantiation rules. Donors can be very generous – until it comes to paying an appraiser. The IRS is litigating this issue and has been winning fairly consistently. If the appraisal does not meet all of the requirements, or if the receipt is not accurate or it is not received timely, no deduction is allowed, and the IRS does not even need to argue about the valuation. For charitable contributions over \$5,000, generally a qualified appraisal prepared by a qualified appraiser must be obtained, and for contributions over \$500,000, the appraisal must be included with the income tax return, which appraisal the IRS can scour to find any detailed technical omissions. For a description of the detailed appraisal requirements, see IRS Publication 561, Determining the Value of Donated Property.

Astonishingly, Ms. McKinnon indicates that in 30 years of practice she has had exactly one appraisal that she reviewed that met all the substantiation requirement rules the first time she looked at it. When clients do not want to pay to use reputable qualified appraisers, a professional advisor has to struggle to work with the appraiser to identify and negotiate the addition of all the necessary changes required to comply with all the rules. That is the most stressful part of her charitable planning practice—making sure that all of the detailed requirements are satisfied so that a donor is entitled to an income tax deduction. That complexity scares donors, and charities do not like to talk about it (for fear of losing a donation). The donors rely on the charity, though, and Ms. McKinnon finds that in representing institutions, she is doing the incredibly detailed review work even though she doesn’t represent the donors. “It is a really difficult area to navigate.... As much as property gifts are great, there is significant appeal to the simplicity of the Camp proposal.”

- f. **Donor Advised Funds; Notice 2017-73.** Notice 2017-34 explains that the IRS is considering regulations under §4967 (regarding prohibited benefits from donor advised funds) to provide that purchasing a ticket to enable a donor, donor advisor, or related person to attend or participate in a charity sponsored event results in a more than incidental benefit, even if the individual pays the “non-charitable” portion of the ticket price. The benefit may also constitute an excess benefit under §4958.

In addition, the Notice announced that the Service is considering adopting the position that distributions from a donor advised fund (DAF) that the distributee charity treats as fulfilling a pledge made by the donor, donor advisor, or related person do not result in more than an incidental benefit if the fund makes no reference to the existence of a charitable pledge when making the distribution from the fund (in effect, a “don’t ask, don’t tell” rule). The concern expressed by some commenters to the IRS was that the fund may have difficulty determining whether a pledge exists and whether it is an enforceable pledge. Of course, the donor could not take a separate charitable deduction for the contribution to the charity from the DAF. Query whether a donor’s pledge agreement could provide that distributions from the donor’s DAF would be treated as contributions in satisfaction of the pledge?

10. Estate Planning in Anticipation of a Contest or a Difficult Beneficiary

The information in this item is based upon information and written materials by S. Andrew Pharies (San Diego, California) and David Baker (Chicago, Illinois).

- a. **Identifying High Risk Cases.** Every client arrives at the attorney’s office wanting a “simple estate plan.” Planners should be sensitive to red flags of high-risk situations: disinheriting a child; unequal distributions among beneficiaries of the same class; multiple marriages with children from different spouses; unequal participation in family businesses by children; elderly or impaired client; impaired beneficiaries; presence of one beneficiary in the estate planning process to the exclusion of others; substantial deviations from prior estate planning documents; and a client having recently left his or her long-time experienced estate planning attorney.

If the document is contested, the planner will be a witness years later. The planner probably will not be the attorney in that contest action, because he or she will be a prime witness. In these situations, a high risk exists that the work product will be closely scrutinized by a litigator who will twist everything that was written down or said to benefit that attorney’s client. Furthermore, all the work that is done after the client dies as a witness, producing documents, determining what is privileged, etc. will probably be uncompensated.

The most important question the attorney will face in the entire case is whether to accept the high-risk case in the first place. If the attorney decides not to take the case, “that means you are sane person.” Many good estate planning attorneys will not accept these cases.

- b. **Planning in Anticipation of a Contest.**
 - (1) **Grounds for a Contest.** The major grounds for contesting testamentary documents are lack of capacity (a higher contractual standard of capacity may apply to documents other than a will or will substitute), undue influence, fraud, duress, or mistake.
 - (2) **Manage Client Expectations.** These are very difficult cases, not just on the lawyer but also on the client. Clients do not understand what “I want to disinherit Johnny” entails. Disinheriting will totally disrupt the relationship between Johnny and his siblings. “Nothing will disrupt sibling relationships more quickly or more effectively than one receiving a larger inheritance than the others.”

Set expectations that the engagement will be expensive. Litigating will contests is incredibly expensive, and planning to avoid contests will also be expensive.

In addition, the client must understand that the planning process will be invasive. The client must lay bare to the world details about his or her health, family, finances, and conflicts that have happened over the years with children. It will not be a pleasant experience.

(3) **Creating the Record.** Habit Two of Stephen Covey's *7 Habits of Highly Effective People* is: "Begin with the End in Mind." In this context, the ultimate goal is that a contest never occurs or that the court will uphold the validity of the document drafted, largely because of evidence accumulated in the planning process, thus preserving the client's testamentary intent. Estate planning in anticipation of a contest or difficult beneficiary involves more than just drafting the document. That is the minor aspect. The engagement is primarily about the planning process of creating evidence that will be used in the trial court or that would be used to forestall having a trial in the first place.

(i) **Competency.** The attorney's opinion about the client's competency is not sufficient – the goal is to create evidence for trial.

Medical Competency Report. Even if the client is perfectly competent, still consider getting an examination from a professional who can testify when the document is being examined. Use a professional with the skill set to evaluate cognitive deficits, including a neurologist, psychologist, neuropsychologist, or psychiatrist who is trained to identify specific deficits. The physician should review the medical record, administer standard tests, and apply those tests to the legal standard of competency.

As an example, §811 of the California Probate Code lists a series of cognitive functions that must be examined in evaluating contractual capacity, including: alertness and attention; level of arousal; orientation to time, place, and situation; ability to concentrate; memory issues; ability to understand and communicate with others; recognition of objects; ability to reason; and ability to use abstract concepts.

The physician should be directed to prepare a written report of findings of cognitive functioning and applying the findings to the competency standard applicable to the documents being signed by the client. The report should state that the physician has reviewed the client's medical records and discuss the impact of the medications the client may be taking. The report should be addressed to the estate planning attorney, and appropriate HIPAA and confidentiality waivers should be executed by the client to allow the physician to reveal medical information to the estate planning attorney AND ALSO to allow the estate planning attorney to circulate the report after the client's death.

Testing at the Time of Execution. The planner must also establish the client's capacity on the day the estate planning documents are signed. The attorneys should question the client in front of witnesses regarding the various elements of capacity required for the particular documents. After the execution ceremony, the estate planning attorney should prepare a memorandum documenting questions that were asked and the client's responses.

(ii) **Undue Influence Third Party Interview.** The estate planning attorney should isolate any beneficiary who unduly benefits under the plan from participation in the planning process. The person should not be present at meetings or a conduit for communication.

Engaging an independent attorney to perform an in-depth interview to establish the absence of undue influence, duress, fraud, or mistake can be quite helpful in defending against a claim based on one of those grounds. The interview would include examining facts relating to the underlying elements of those claims. California has adopted a statutory list of factors that a court must consider when evaluating an undue influence claim, and that list provides a helpful guide to anybody conducting such a third party interview. The list includes factors relating to the vulnerability of the victim, the influencer's apparent authority, actions or tactics used by the influencer, and the equity of the result. CALIF. WELF. & INST. CODE §15610.70(a)(1) – (4).

An attorney preparing such an interview will understand that he or she will be caught up in the litigation, so the third party interviewing attorney will charge a substantial premium for this type of engagement.

(iii) **Videotape.** Video is very powerful and can overcome reason. In some jurisdictions it is not admissible at all; in others it is admissible as a state of mind exception to the hearsay rule. If a client has ZERO impairments (good appearance, perfectly calm, no strange fright, looks beautiful on video), the planner might consider videotaping the execution. If ANYTHING is off (stage fright, movement issue, speech issue, speech is not as good as it used to be, etc.) stay away from videotape because it can be extremely prejudicial. If video is used, employ a professional videographer.

c. **Taking Steps to Prevent the Contest; In Terrorem Clauses.**

(1) **General Description.** The in terrorem clause is a forfeiture provision— a person who unsuccessfully contests the document is disinherited. For this to be effective, the clause must be baited by leaving the potential contestant something substantial that the individual is reticent to gamble losing in order possibly to get something larger in contest litigation.

(2) **Define Triggers.** Actions that trigger the clause must be identified specifically. These could include:

- contesting the will or codicil or in the exercise of a power of appointment or transfer of property;
- contesting a revocable trust or other trust; contesting any discretionary action taken by the executor or trustee;
- seeking a declaratory judgment regarding whether any specific anticipated action would violate the clause;
- bringing any tort action against an identified group of persons including the imposition of a constructive trust;
- seeking a court adjudication regarding testamentary or contractual capacity; or
- cooperation in any similar actions brought by any other person.

(3) **What Documents.** The clause should identify specifically what documents that are attacked would trigger the clause (which could include documents outside the testamentary document containing the clause).

(4) **Who.** The clause should identify persons covered, and it could be customized to cover just particular persons or class of persons or to accept out a particular person or to trigger some particular acts as to one person but not as to another person.

(5) **Defense Costs.** The clause should authorize the executor or trustee to defend against any action described in the clause. The executor or trustee should be authorized to retain counsel and pay fees from the property of the trust or estate, and that the contesting person is disqualified from objecting to the defense, payment of fees and expenses, or the selection of counsel.

Consider not requiring reasonable compensation. Parties in litigation use costs as a weapon. Take away that weapon by allowing the fiduciary to hire any counsel desired, regardless of their rate, to be paid under their customary hourly rate (even if that rate is considered unreasonable), and to be paid without prior court approval. Provide that no one can question or even discover the amount of the fees.

(6) **Allocation of Costs.** Allocate fees defending a contest against any bequest made to the contestant. (Some courts have refused to enforce that type of provision.)

(7) **Probable Cause.** Most states apply a reasonable cause standard, and will not enforce an in terrorem clause if the client had probable cause. Probable cause is an objective standard generally described as evidence that would lead a reasonable person, properly informed and advised, to conclude that a substantial likelihood existed that the challenge would be successful, measured at the time the challenge is filed.

(8) **Strategy to Establish Lack of Probable Cause.** After the client dies, the estate planning documents, along with the competency report and the third-party interview report are sent to the beneficiaries. Distributing the reports has two effects. (1) It provides an argument that the person does not have probable cause. (2) As a practical matter, it is an incredible deterrent to a contest. This strategy has been successful in a variety of situations in which the beneficiary had consulted a litigation attorney about filing a contest.

d. **Planning in Anticipation of Challenge to the *Participants* in the Planning Process-Tort Claim of Intentional Interference with Testamentary Expectancy.**

Some states recognize the tort of intentional interference with testamentary expectancy. These can be scary actions involving punitive damages, and can be used as a weapon against the drafting attorney and other participants in the planning process.

The typical elements of this tort action include (1) a testamentary expectancy, (2) tortious interference with that expectancy, (3) causation – that the interference caused a change of the testamentary disposition, (4) damages, and (5) that no adequate remedy exists in probate.

About all that can be done to avoid this type of challenge is to add such a tort claim as a trigger under the no contest clause. In addition, having the competency report and undue influence report would assist in defending against such a tort claim.

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- e. **Preventing Post-Death Modification of Estate Plan.** While actions such as decanting, nonjudicial or judicial modifications, settlement agreements, etc. can provide great flexibility, they also can be used to disrupt the client's intent. Those alternatives may provide very helpful flexibility for plans that last for decades, but may not be needed for plans that will be distributed relatively quickly.

The planner should address with the client whether the priority is to protect testamentary intent or to provide flexibility. If the primary goal is to protect the estate plan, the planning documents can prohibit a trustee from decanting, litigating a case to reform the document, consenting to any modification of the document, or entering into a settlement agreement that would alter the terms of the trust in any way.

- f. **Planning in Anticipation of Difficult Beneficiaries.** Disgruntled beneficiaries can use "weaponized fiduciary duties" and threats of lawsuits in an attempt to bully the fiduciary. The planning attorney can take steps to mitigate the impact of such claims.

(1) **Structure of Gifts.** If the plan leaves a beneficiary a share of the residuary estate, that beneficiary may complain about everything done in the administration. Alternatively, give the beneficiary a specific bequest of a particular property (the beneficiary could complain only about actions with respect to that property), or just give the beneficiary a pecuniary amount (the beneficiary could only complain about the timing of the payment of that pecuniary amount). Structure the plan so that the recipient of the specific bequest or pecuniary bequest would not bear any estate tax (or else the beneficiary could complain about actions that impact the amount of the estate tax).

For gifts in trust, use one of two extremes – give NO discretion regarding distributions (for example, an annuity payout to be paid on specified dates) or will give COMPLETE discretion regarding distributions.

(2) **Modify Fiduciary Duties.** The settlor of a trust can modify the fiduciary duties of loyalty, investing prudently, impartiality, self-dealing, etc. The duties can be customized, so that they apply to some beneficiaries and not others, or applied to some fiduciaries and not others. Some duties cannot be waived or modified, such as the duty to account, or the duty to keep beneficiaries informed.

Include a statement about why fiduciary duties are being modified. Precatory language can be very powerful in convincing the court to do something that it would not ordinarily do.

(3) **Exculpation.** An exculpation clause provides that a person who breaches a fiduciary duty still would have no (or a reduced level of) liability. The exculpation clause can be customized to protect the client's favored trustee against the client's disfavored beneficiary.

(4) **Use Business Entities.** Assets can be managed inside an LLC that is owned by the trust. Duties of the managers of business entities are lower than fiduciary duties applicable to trustees and can be modified to a much greater extent. In addition, establishing situs is much easier. Having a Delaware sitused trust likely requires having a Delaware trustee and perhaps other nexus, but having a Delaware LLC merely requires that it be formed in Delaware.

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- g. **Limiting Actions By a Successor Trustee.** Trust documents typically provide that a successor trustee has no duty to sue or monitor the actions of a predecessor trustee, but typically do not prohibit a successor trustee from suing a predecessor. The successor trustee may hold the attorney-client privilege of the office of trustee, and typically has standing to sue the predecessor and the predecessor trustee's attorney, which is sometimes done for strategic reasons. The trust document could provide that a successor trustee is prohibited from bringing actions against a predecessor trustee or the trustee's attorneys.
 - h. **Mandatory Arbitration Clauses.** Some (but not all) states allow a mandatory arbitration provision in trusts and testamentary documents. These provisions allow the settlor to create the forum in which disputes would be litigated, to pick the arbitrator or establish a procedure for doing so, and to modify the rules of arbitration (for example to provide a particular document will be admissible even though it might not be admissible in a court action).

11. Planning for an Aging Population

- a. **Statistics About the Aging Population.** Forty million people in the U.S. are age 65 or older, representing 13% of the population. For individuals who live to age 65, 25% will live to age 90, and 10% will live to age 95. By 2050, the number of people over age 65 will more than double to represent 25% of the population, and the fastest-growing segment of those over 65 will be people over age 85.
- b. **Alzheimer's Disease.** Five million people in the U.S. have Alzheimer's disease. It is not just an old person's disease; 200,000 persons under age 65 have Alzheimer's.

The cost is staggering. The cost of caring for Alzheimer's patients is \$260 billion per year (compared to \$66 billion per year for cancer patients). By 2050, the cost will rise to over \$1 trillion per year, and the government pays for over two-thirds of this expense.
- c. **Elder Law Myths.**
 - (1) It won't happen to me. (In reality, 70% of those age 65 will need some form of long-term care, and 50% will need nursing home care.)
 - (2) Even if I need long-term care, Medicare will pay for it. (Medicare pays for acute illness (stroke, heart attack, etc.) but does not pay for chronic disease (Alzheimer's disease, Parkinson's, etc.); Medicare does not pay for custodial care; it will cover only a maximum of 100 days after a hospital stay to assist during short-term recovery.)
 - (3) Long-term care is not that expensive. (The average cost is \$100,000 per year, but in major metropolitan areas can be much higher than that.)
 - (4) At least I won't have to pay for my spouse's care. (With some exceptions, spouses are responsible for the cost of each other's long-term care.)
 - (5) I'll deal with this later. (The ability to make one's financial and medical decisions diminishes with age; failure to make these decisions can result in family conflict and expensive litigation.)

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- d. **Assisted Living Facilities.** A signed admissions agreement is typically required prior to admission. These are often nonnegotiable, but beware of provisions regarding personal guarantors. A family member signing on behalf of a resident should sign “as agent” to avoid being personally responsible for costs of the facilities.

The cost of an assisted living facility can range from \$4,000 to more than \$10,000 a month. Be aware that add-ons to the daily rate for special services are common.

- e. **Nursing Home.** Nursing homes participating in Medicare and Medicaid programs must meet certain federal requirements.

Nursing homes cannot require or request a third-party guarantee of payment as a condition of admission or continued stay in the facility. A common ploy has been to require a “resident representative” who can sign the contract without incurring personal liability to provide financial payment from the resident’s income and resources. Many nursing home admissions attempt to impose additional liability on the responsible party even though not allowed under federal law.

A nursing home may not require a security deposit for an individual being admitted from a hospital. If a qualifying hospital stay has not occurred, the facility can require payment in advance for the first month’s charges and a two-month security deposit (but not more).

Mandatory pre-dispute arbitration provisions are common in nursing home admission agreements. A federal agency announced in 2016 that such provisions were no longer permitted, but a federal district court issued an injunction to prevent enforcement of the ban, and in June, 2017, the agency issued a proposed rule that removes provisions prohibiting binding pre-dispute arbitration agreements.

- f. **Continuing Care Retirement Community.** CCRCs offer independent housing, assisted living, and nursing home care. They are attractive facilities and accommodate spouses with different needs. They can be very expensive, however. An entrance fee of \$100,000-\$1 million (or more) is required in addition to a monthly fee of several thousand dollars.

- g. **Long-Term Care Insurance.** Long-term care insurance is difficult to obtain. Most insurance companies have got out of this business because it is expensive, and the policies have been way underpriced. (General Electric was one of the worst performing stocks in 2017, and it was because of the long term care insurance division.) Only a few reputable companies still sell this coverage.

Only 7 million people in the country have long-term care insurance. Sales of this insurance have been flat, and from 2002, sales have declined significantly.

A hybrid long-term care/life insurance product is a newly available product.

Most states charge more for female policies. Claims for females are much higher than for males, because male spouses typically predecease female spouses, and when the female spouse needs long-term care, her husband is not alive to provide in-home care.

- h. **Elder Abuse.** See Item 26 for a discussion of various issues regarding elder abuse, including the ability to sue with respect to activities of a trustee of a revocable trust or an agent under a power of attorney while the settlor or principal is still alive.

12. New Partnership Audit Rules Overview

This brief overview summary of the new partnership audit rules is based on materials by Richard Robinson (Denver, Colorado). Partnership and LLC agreements should be amended as a result of the new rules, and the materials contained detailed practical suggestions, with a sample form, for amendments.

- a. **Overview.** The Bipartisan Budget Act of 2015 replaced the existing partnership audit regimes, including provisions under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), with new partnership audit rules that apply to partnership taxable years beginning after 2017. The new rules are meant to assist the IRS in auditing partnerships, and are not designed to increase fairness. They will likely result in more partnership tax audits and more tax revenues collected from partnerships and partners. The general approach is that the audit will occur at, and any adjustment will apply at, the partnership level (particularly for large partnerships). Taxes will be paid by the partnership, not the partners, which will avoid the necessity of a multitude of individual tax audits of the individual partners.
- b. **Partnership Representative.** Every partnership must designate a “partnership representative” on its federal income tax return for each tax year beginning after 2017. The partnership representative has sole authority to make elections and represent and bind the partnership (and the partners) in all administrative and court proceedings involving adjustments to the partnership’s federal income tax return. All notices and communications will be sent only to the partnership representative. The individual partners have no right to participate in the audit.
- c. **Partnership Level Determination and Payment of Income Tax.** The general rule is that partnership income tax audits are conducted at the partnership level and any resulting income tax will be paid by the partnership and not by the individual partners.

Two important exceptions from the general rule are: (1) an “election out” by which an “eligible partnership” can elect to have audits and tax liability conducted at the partner level; and (ii) a “push-out election” by which the partnership representative requires each partner to report its share of any audit adjustments on the partner’s return and to pay any resulting income tax liability.

The partnership level income tax liability resulting from an audit (the “imputed underpayment”) including penalties and interest will be assessed and collected from the partnership for the “adjustment year” in which the adjustments become final, not the “reviewed year” that was audited. This can result in a **huge economic distortion** if the reviewed year partners are not the same as the adjustment year partners.

- d. **Eligibility for Election Out; Partnerships With Trusts as Partners Not Eligible.** Only eligible partnerships they make the election out of the new audit rule regime. Requirements of eligible partnerships include: (1) not more than 100 partners; and (2) the partnership can only consist of eligible partners, including individuals, C corporations, foreign entities that would be treated as C corporations if they were domestic entities, S corporations, and estates of deceased partners (but not including partnerships, trusts, or disregarded entities).

The exclusion of trusts (including revocable trusts, grantor trusts, nongrantor trusts, and charitable remainder trusts) from this list is of vital importance in the estate planning community. As a general rule, the new audit rules apply to large partnerships, and small partnerships can opt out of the new rules. However, family partnerships with trusts or disregarded entities as partners do not have that option available.

The preamble to the regulations implementing the new audit rules explains that the IRS rejected numerous suggestions to exercise its regulatory authority to expand the types of entities that can qualify as eligible partners because that would unduly burden the IRS by increasing the number of partnerships subject to the deficiency procedures that the IRS must follow for partnerships that elect out of the centralized audit regime.

- e. **Amendments Needed.** A variety of issues should be covered in amendments to partnership and LLC agreements, including rules governing the partnership representative, the election out decision, imputed underpayments and modifications, the push-out election, economic distortion provisions, and administrative adjustment requests.

The written materials by Richard Robinson have a detailed discussion of each of these issues, together with sample provisions.

13. Fiduciary Accountings to Facilitate Planning and Mitigate Risk

Trust accountings offer a variety of advantages, but are often not prepared for trusts with non-professional trustees. This summary reflects comments by Scott Ditman (CPA New York, New York) and Josh Rubenstein (New York).

- a. **General Description.** Fiduciary accountings reflect the transactions of the estate or trust, and accurately reflect the amount of trust income and principal, as determined under state law in accordance with the terms of the trust agreement. A fiduciary accounting may or may not be prepared in accordance with local procedures as to the formatting of information that must be included in an accounting to be filed with a court.

The incremental extra cost of preparing a fiduciary accounting is not great in light of the benefits and protection that it provides, as discussed below.

- b. **Potential Benefits.**

(1) **Income Tax Effects.** The amount of fiduciary accounting income can affect the preparation of the fiduciary income tax return in various ways. For example, a trust that distributes more than the fiduciary accounting income in a year is a complex trust. Also, under the tier rules, DNI is allocated first to required distributions of current year fiduciary accounting income. §662(a)(1). Schedule B, Line 9 of the Form 1041 requires listing “Income required to be distributed currently.” If the trust has a mandatory income distribution requirement, that line cannot be completed without a fiduciary accounting to determine the amount of fiduciary accounting income.

(2) **Transparency.** The accounting is a way to communicate with beneficiaries about trust activities. At a minimum, informal accountings should be sent to beneficiaries on an annual basis.

(3) **Communication Opportunity.** Ideally, the trustee and planners would meet with beneficiaries to discuss the accounting and the trust activities. Open communication can resolve many problems that might otherwise arise.

(4) **Fiduciary Protection.** Providing the beneficiaries with complete information about trust activities should begin a statute of limitations to run with respect to breach of duty claims. (Some states have very short statutes of limitations with respect to accountings. Florida provides that the accounting can state at the top that a beneficiary has only 6 months to bring legal action with respect to activities disclosed on the accounting.) The statute of limitations for breach of fiduciary duty claims does not begin to run until the fiduciary accounts or repudiates the obligation to account, and it begins running only as to activities actually disclosed on the accounting.

Providing full information on an annual basis avoids the practical reality that hindsight many years later may suggest that a different course of action would have been preferable from a beneficiary's standpoint.

(5) **Releases.** On an interim basis, the interested parties may be requested to "sign-off" on the accountings. As with all releases, any such release is valid only as to information disclosed to the signer. Despite this important advantage of accountings, "everybody stands on their heads to avoid accountings. It's the strangest thing."

How do you get beneficiaries to agree to sign-off on the accountings? "When beneficiaries are treated with respect and believe that their feelings are heard, they are much more likely to sign-off. This stuff is often not about dollars – it's about respect and communication." "The fight is about principle – "LE," not principal – "AL."

Also, while someone is still alive, there's always moral persuasion (like convincing children not to exercise withdrawal rights over Crummey trusts).

Children sometimes are fearful of the patriarch or matriarch and are unwilling to complain while they are alive and able to retaliate. Children may be much more willing to sign-off on accountings on an annual basis while the parents are still living.

As an example, if distributions are made to the current beneficiary, who is using funds to make gifts to one of her three children, having annual meetings with all of the children to discuss what is being done puts all the children on notice. They won't like it, but they won't object to their mother's ability to make her own decisions.

(6) **Formalizes a Process.** Having annual accountings and disclosing all transactions during the year is a way of formalizing that a *process* exists for making fiduciary decisions. "You don't have to end up having been right. You just have to have a process where you made the analysis."

(7) **Foundation For Various Fiduciary Decisions.** The annual report to beneficiaries and the fiduciary accounting serve a variety of purposes. The fiduciary accounting serves as the books and records for the trust that is used to calculate the annual fiduciary accounting income and to prepare the tax return, to compute the annual trustee commission, to serve as the jump off point for budgeting cash flow in the current year and in the following year, and to readily assist in providing a liquidity analysis.

(8) **Opportunity for Planning With Beneficiaries' Buy-In.** Open communication with full information about the trust activities may also open up planning opportunities. For example, in one situation such open communication allowed all of the beneficiaries to agree on a plan maximizing, within the discretion of trustees under the instrument and state law, the allocation of expenses to income and the allocation of income to depreciation reserves, thus dramatically reducing the amount distributed to the surviving spouse under a mandatory income distribution requirement. Roughly \$60 million of estate tax savings resulted from adopting this approach over the surviving spouse's lifetime (which passed to grandchildren under a GST grandfathered trust).

(9) **Avoiding Enormous Expense Later.** If annual fiduciary accountings are not prepared and if litigation erupts years later regarding the trust, preparing trust accountings to reflect activities over decades will be enormously expensive.

14. Portability

- a. **Brief Background.** Legislation in 2010 and 2012 allows portability of any unused applicable exclusion amount for a surviving spouse of a decedent who dies after 2010 if the decedent's executor makes an appropriate election on a timely filed estate tax return that computes the unused exclusion amount.

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 Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

- b. **Using QTIP Trust Planning With Portability, Rev. Proc. 2016-49, Modifying and Superseding Rev. Proc. 2001-38.** The IRS on September 27, 2016 released Rev. Proc. 2016-49 to modify and supersede Rev. Proc. 2001-38 and clarify that portability can be used in connection with QTIP trusts. For a more detailed discussion, see Item 16.b of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at www.Bessemer.com/Advisor.
- c. **Relief Procedure for Extension of Time to File Returns to Elect Portability, Rev. Proc. 2017-34.** Section 2010(c)(5)(A) requires that the portability election be made on an estate tax return for the decedent whose unused exclusion amount is being made available to the surviving spouse. Rev. Proc. 2017-34 provides a relief procedure through the later of January 2, 2018 or the second anniversary of the decedent's date of death in certain cases if the estate was not otherwise required to file an estate tax

return. This is a very helpful relief measure (which avoids the necessity of the taxpayer paying a hefty user fee for a ruling under §301.9100-3 to obtain an extension of the time for filing the return to make the portability election). For a more detailed discussion, see Item 16.d of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at www.Bessemer.com/Advisor.

- d. ***Estate of Vose, Court Forces Executor to Make Portability Election Despite Marital Agreement Waiving All of Surviving Spouse's Rights to Decedent's Estate.*** The Oklahoma Supreme Court affirmed the lower court's decision forcing the executor to file an estate tax return making the portability election, even though the surviving husband had signed a prenuptial agreement waiving "all claims and rights, actual, inchoate, vested, or contingent" in the estate. *In re Matter of the Estate of Anne S. Vose v. Lee*, __ P.3d __, 2017 WL 167587 (Okla. Jan. 17, 2017). (Observation: The family's pronunciation of "Vose" rhymes with "gross" not "doze.") This is a case of national first impression, addressing (i) whether a prenuptial agreement waiving "all claims and rights" to an estate waived any interest that the surviving spouse had in the DSEU amount if the portability election were made, and (ii) an executor's fiduciary duty to make the portability election where the spouse was not a beneficiary of the estate.

Regarding the prenuptial agreement issue, the court observed that a valid waiver requires "full knowledge of the rights intended to be waived," that §2010 (enacted after the agreement was signed) granted the husband "a potential interest in a part of Decedent's estate," and distinguished the waiver of all "claims and rights" in the estate by concluding that "[t]he portable DSUE is not simple property acquired by one party over the course of the marriage according to existing laws in effect when the agreement was made." This is a case of first impression regarding the reach of a pre-existing prenuptial agreement attempting to waive "all rights" in an estate, whether known or unknown, but that pre-dated the portability election and obviously did not mention portability. The case emphasizes the importance of specifically addressing the parties' intentions regarding portability in structuring prenuptial agreements. See generally George D. Karibjanian and Lester B. Law, *Portability and Prenuptials: A Plethora of Preventative, Progressive, and Precautionary Provisions*, BNA Estate, Gift and Trusts J., (March-April 2013).

The court emphasized that the personal representative had a fiduciary relationship to "all parties that have an interest in the estate," and that the surviving husband is the only person that has "an interest in and the ability to use the DSUE" amount. The personal representative argued that the estate should be able to demand consideration from the surviving husband, but the court focused on the fact that the DSUE would be lost if the election were not made and that the surviving husband agreed to pay any costs associated with filing the return to make the election.

For a discussion of the impact of the *Vose* case, see Lester Law & Howard Zaritsky, *In re Matter of the Estate of Anne S. Vose v. Lee: Court Forces the Portability Election – Is Pandora's Box Open?*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2513 (February 8, 2017).

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- e. **Statute of Limitations Not Run on DSUE Amount Following First Spouse's Death.** *Sower v. Commissioner*, 149 T.C. No. 11 (September 11, 2017) concluded, based on the clear words of §2010(c)(5)(B), that the statute of limitations does not run, following the first spouse's death, on the determination of the amount of the DSUE following the surviving spouse's death. The correct amount of the DSUE may be examined on the surviving spouse's estate tax return, even if that is years later.
 - f. **Planning Considerations.** For a detailed discussion of planning considerations, including major factors in bypass planning versus portability, methods of structuring plans for a couple to maximize planning flexibilities at the first spouse's death, ways of using the first decedent-spouse's estate exemption during the surviving spouse's life, whether to mandate portability, whether to address who pays filing expenses to make the portability election, state estate tax planning considerations, and the financial impact of portability planning decisions, see Item 5 of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at www.Bessemer.com/Advisor.

15. Creating Trust With Beneficiary As Deemed Owner Under §678, "Beneficiary Deemed Owner Trust" (BDOT); Application of Letter Ruling 201633021

a. Underlying Statutory Provision

Section 678 includes these relevant provisions:

(a) General Rule. –A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

(b) Exception Where Grantor Is Taxable. Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

b. Overview Description of BDITs and BDOTs.

What has been termed the "beneficiary defective inheritor's trust" (BDIT) by Richard and Steve Oshins, if a trust is not a grantor trust as to the trust's settlor and if a beneficiary has a Crummey power to withdraw **all of the contributions** to a trust, the beneficiary would be the deemed owner of the trust under §678(a)(1) during the period of time while the withdrawal power exists and arguably under §678(a)(2) after the withdrawal power has lapsed (or within the words of §678(a)(2) has been "partially released" assuming the lapse is treated as a release for §678 purposes). See, e.g., Richard A. Oshins, *The Beneficiary Defective Inheritor's Trust ("BDIT")*: *Finessing the Pipe Dream*, CCH Practical Strategies (Nov. 2008); Jonathan

Blattmachr, Mitchell Gans & Alvina Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC L.J. 106 (Fall 2009). The approach uses withdrawal powers over the **entire contribution** to the trust and **relies primarily on §678(a)(2)** following lapses of the withdrawal powers. Under this approach, relatively small gift transfers (typically \$5,000) are made to the trust so that the lapse of the withdrawal power does not result in the beneficiary being treated as having made a transfer to the trust, which would cause partial estate inclusion in the beneficiary's estate. The practical problem with the BDIT is how to leverage a small \$5,000 gift to a trust into a significant size through later transactions with the trust. (See paragraph m below for a further discussion of BDITs and potential planning concerns with BDITs.)

Ed Morrow suggests another approach, in which the beneficiary has the right to withdraw an amount equal to **all of the trust's taxable income** in any given year (from all of the trust assets) but does **not have the right to withdraw the entire contribution** to the trust. The approach **relies primarily on §678(a)(1)** because the beneficiary holds a withdrawal over taxable income *each* year. This approach does not have the limitation of allowing only small gifts to the trust; gifts of any size could be made to the trust because there is no concern of keeping the entire contribution within the "5 or 5" power amount. Mr. Morrow calls this a "beneficiary deemed owner trust" ("BDOT"). For an outstanding summary and analysis of this approach, see Ed Morrow, *IRC 678(a)(1) and the "Beneficiary Deemed Owner Trust" (BDOT)*, LEIMBERG ESTATE PLANNING NEWSLETTER #2516 (Sept. 5, 2017).

- c. **Why the BDOT Works Under §678(1)(1).** Observe the highlighted words below in §678(a)(1):

"A person other than the grantor shall be treated as the owner of **any portion** of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus **or the income** therefrom in himself..."

The BDOT approach is based primarily on the "**OR income**" phrase in §678(a)(1).

It is easy to ignore or misinterpret the "power ... to vest ... the income" portion of §678(a)(1), since there have been fewer reported cases, ruling and articles on trust structures that only allow withdrawal powers over taxable income, yet dozens of PLRs and articles on withdrawal powers over corpus. Treatise have very little if any discussion of this potential variation.

Yet.

But there is no reason to ignore the "or the income" in the statute and no requirement under §678(a)(1) that a beneficiary/powerholder have any power over corpus beyond the income attributed to corpus to shift all the income taxation to the beneficiary. Id.

"Income" in §678 Means Taxable Income. The regulations governing the grantor trust rules (§§671-679) clearly provide that the reference to "income" unless specifically limited, refers to income determined for tax purposes and not to income for trust accounting purposes. Treas. Reg. §1.671-2(b). (In contrast, for purposes of the non-grantor trust provisions of Subchapter J (Parts A-D, F), a reference to income generally means trust accounting income. Treas. Reg. §1.643(b)-1.)

Withdrawal Power Should Exist Over All Taxable Income. In order for the beneficiary to be treated as the owner of the entire trust for income tax purposes under §678(a)(1), the withdrawal power must apply to all net taxable income during the year, including capital gains. If a trust agreement merely provides that the

beneficiary may withdraw “income,” under state law principles that would generally refer to income determined for trust accounting purposes which would not typically include extraordinary dividends or capital gains. To cause the taxable income attributable to the corpus portion of the trust also to be treated as owned by the beneficiary, the withdrawal power must apply with respect to an amount equal to all of the net taxable income. Having the corpus portion of the trust being treated as owned by the beneficiary for income tax purposes is extremely important if the beneficiary wishes to sell assets to the trust and have the transfer treated as a non-recognition event under the reasoning of Rev. Rul. 83-12.

Case Law and Letter Ruling Support. Case law supports the conclusion that a power to withdraw taxable income attributable to trust principal, without the power to withdraw the principal itself, causes the powerholder to be taxable on the taxable income attributable to trust principal. *Campbell v. Commissioner*, T.C. Memo 1979-495 (beneficiaries had the power to cause the trustee to distribute capital gains; beneficiaries did not request and the trustee did not distribute the capital gains income to the beneficiaries, but they “were deemed to be the owners of the capital gains income” under §678(a)(1)).

Private letter ruling 201633021 also supports this conclusion. In that ruling, trust #1 had the power to withdraw from trust #2 “any dividends, interest, fees and other amounts characterized as income under §643(b) of the Code” and the net short term capital gains and the net long term capital gains. Trust #1 did **not** have the power to withdraw principal of trust #2 beyond the taxable income. The ruling concluded that all of the taxable income of trust #2, including the net capital gains, were taxed to trust #1 under §678(a)(1).

Whether Taxable Income Amount Is Actually Withdrawn Is Irrelevant Under §678. Income is taxable to a powerholder under §678(a)(1) whether or not the amount is actually withdrawn. If it is withdrawn, such withdrawal is generally a non-taxable event because it is not a distribution that is reported under the distribution rules for non-grantor trusts. Rev. Rul. 67-241. Indeed, §678(a)(1) applies if the powerholder is a minor for whom a guardian who could exercise the power has not been appointed. Rev. Rul. 81-6; *Trust No. 3 v. Commissioner*, 285 F.2d 102 (7th Cir. 1060). Failure to withdraw the portion of taxable income that exceeds the greater of \$5,000 or 5% of the trust assets, however, could have an effect for transfer tax purposes and for purposes of creditor access to the trust assets, as discussed below.

- d. **Withdrawal Power Over Net Taxable Income Amount Should be Exercisable From All Trust Assets; Impact of Lapse of Withdrawal Power in Excess of “5 or 5” Power.** The trust agreement may provide that failure to withdraw the taxable income amount in a particular year would lapse and could not be exercised in a later year. If so, and if the lapsed power exceeds the greater of “(A) \$5,000, or (B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied,” the power holder will be treated as having made a gift of the excess amount (unless it is an incomplete gift because of retained powers over the trust) [see §2514(e)], and the portion of the trust attributable to such excess amount would be included in the powerholder’s gross estate for estate tax purposes [see §2041(b)(2)].

For most years, the net taxable income of a trust will be less than 5% of the trust value. To use the full trust value in order to measure the 5% amount, the beneficiary should be able to withdraw the net taxable income amount from all of the trust assets. See Rev. Rul. 66-87 (where beneficiary had the power to withdraw accounting income, the 5% element is calculated based just on the accounting income, not all trust assets, reasoning that "the annual trust income ... is 'the assets out of which ... the exercise of the lapsed powers could have been satisfied'" and apparently assuming that the trust agreement did not permit the withdrawal power to be satisfied from all trust assets). Indeed, Crummey withdrawal powers of assets contributed to a trust, up to the annual exclusion amount, typically use 5% of the entire trust fund as the appropriate 5% amount for purposes of the lapse exception. However, *Fish v. U.S.*, 432 F.2d 1278 (9th Cir. 1970), held that the 5% amount, when applied to a power to withdraw "all or part of the net income of the trust for that year" was only 5% of the income, not 5% of the trust assets. The taxpayer argued that since the income payable to the decedent, had she demanded it, would have been payable either from corpus or income, the entire trust represents "assets out of which, or the proceeds out of which, the exercise of lapsed powers could be satisfied." The court disagreed, observing that

even if the trustee could have satisfied the demand for income out of either corpus assets or income funds, a point which we do not here decide, the distribution would necessarily have been a distribution of income as a matter of federal tax law or as a matter of trust accounting, since the decedent had no power whatever to invade the corpus of the trust.

The court was satisfied from a reading of the statute and legislative history that the appropriate test is 5% of the "trust or fund in which the lapsed power existed" and that the power of appointment existed only with respect to the trust income. The IRS cited *Fish* in Rev. Rul. 85-88, 1985-2 C.B. 201 ("where a power of appointment is limited to annual trust income, the 5 percent test is based on annual trust income, not the amount of trust corpus"). Neither *Fish* nor the Ruling addressed how the 5% portion would be determined if the trust instrument stated explicitly that the beneficiary had the right to withdraw income, but could withdraw that amount from any of the trust assets.

If the amount of the net taxable income that can be withdrawn in a particular year exceeds the "5 or 5" amount (and the 5% amount may just be 5% of the income), the preferred approach would be either (a) for the powerholder to withdraw such excess amounts, or (b) for the withdrawal power to include a "hanging power" so that the amount lapses each year only up to the "5 or 5" amount. If the beneficiary has continuing aggregate unexpired powers, the beneficiary's estate would include that full amount in the beneficiary's gross estate at the beneficiary's death.

- e. **Spendthrift Protection Issues.** The beneficiary's creditors ordinarily could not reach assets in a third-party spendthrift trust. Does that change because the beneficiary had the power to withdraw assets from the trust; is the beneficiary treated as a transferor to the trust as to that portion of the trust? If so, the trust may nevertheless be protected from the beneficiary's creditors if a state "self-settled trust" law applies. Even if the trust does not provide creditor protection for all self-settled trusts where the settlor is a discretionary beneficiary, almost all states treat the withdrawal powers that were within the "5 or 5" amount as not causing the beneficiary to be treated as having made a transfer to the trust for creditor access

purposes. *E.g.*, Tex. Prop. Code §112.035(e) (lapse in any year not exceeding 5 or 5 amount [or gift tax annual exclusion amount if greater]) & §112.035 (f)(B)(3) (present withdrawal power not exceeding 5 or 5 amount). See Ed Morrow, *IRC 678(a)(1) and the "Beneficiary Deemed Owner Trust" (BDOT)*, LEIMBERG ESTATE PLANNING NEWSLETTER #2516 n.64 (Sept. 5, 2017)(also references a 50-state survey chart prepared by Mr. Morrow regarding trust assets subject to withdrawal powers).

- f. **Not A Grantor Trust as to Settlor.** The normal grantor trust rules typically “trump” §678. Section 678(b) provides that “Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.” The reference in §678(b) to “income” means taxable income (as discussed in paragraph c above), so §678(a) would clearly not apply to a power to withdraw taxable income if the trust is otherwise a grantor trust as to the original settlor of the trust.
- g. **Testamentary Trust of Which Surviving Spouse is Deemed Owner Under §678.** Following a spouse’s death, testamentary trusts created for the surviving spouse could be treated as owned by the surviving spouse for income tax purposes, allowing the surviving spouse to enter into sale transactions with the trusts without incurring recognition events and to allow the surviving spouse to pay the ongoing income tax of the credit shelter trust to build more value in the trust that would pass free of estate tax at the surviving spouse’s subsequent death. (For a QTIP trust, the withdrawal power should include the greater of the net taxable income or the trust accounting income in order for the trust to satisfy the qualifying income interest for life requirement of a QTIP trust. See §2056(b)(7)(B);Treas. Reg. §20.2056-7(d)(2) making reference to §20.2056-5(f), including §20.2056-f(8) (spouse has the right exercisable at least annually to require distribution to herself of the trust income).
- If both the credit shelter trust and the marital trusts are treated as owned by the surviving spouse for income tax purposes under §678, the credit shelter trust could engage in estate freezing transactions with the marital trust to shift future appreciation from the marital trust to the credit shelter trust (to minimize estate inclusion at the surviving spouse’s subsequent death and to maximize accumulations in the GST exempt trust) but without having a current recognition event for income tax purposes.
- h. **Broad Use For Beneficiaries of Testamentary Trusts.** This approach might be used broadly for testamentary trusts, to permit the beneficiary to have the flexibility of entering into transactions with the trusts and to allow the trusts to grow more quickly by having the beneficiary pay income taxes with respect to trust income with the beneficiary’s outside assets (to maximize the amount that would be excluded from the beneficiary’s estate and to maximize the amount that might accumulate in GST exempt trusts). To the extent that the beneficiary did not want to pay the income tax with outside assets, the beneficiary could exercise the withdrawal power over a sufficient amount to pay the income tax attributable to the trust income.
- i. **Use With Inter Vivos Trusts.** The BDOT approach could be used for inter vivos trusts as well. To the extent that the trust is legitimately created and funded by a third party, the trust would be treated as owned by the beneficiary for income tax purposes in future years. Thus, the trust would achieve the general advantages of

the BDIT trust, but the severe restrictions on the amount that could be funded into a BDIT would not apply. The BDOT could be funded with a large enough amount so that the beneficiary could sell assets to the trust under a traditional “rule of thumb” approach of having 10% equity in the trust without the necessity of using guarantees or other approaches to justify having the trust purchase substantial assets from the beneficiary in return for large notes from the trust.

Alternatively, a “standard” inter vivos grantor trust could provide that following the grantor’s death, the beneficiary would have the withdrawal power over all taxable income or grant a protector the authority to grant such a withdrawal power to a beneficiary. The trust would be a grantor trust as to the original grantor for the grantor’s lifetime and thereafter the trust would be (or could be if the protector granted the beneficiary a withdrawal right over taxable income) deemed to be owned by the beneficiary/powerholder under §678.

j. **Administrative Advantage—Eliminate Need to File Fiduciary Income Tax**

Returns. If the trust is a grantor trust as to the beneficiary under §678, the trust would not need to file a complete fiduciary income tax return (Form 1041) each year. Some planners may view this as a primary advantage of structuring the trust to be a grantor trust as to the beneficiary.

If a grantor trust files a Form 1041, the form is left blank, and a statement is attached indicating the income and deduction information that has been communicated to the deemed owner for inclusion on the deemed owner's Form 1040. The grantor trust box on the Form 1041 should be checked. In some circumstances, no Form 1041 need be filed (and the trustee of the trust does not need to obtain a taxpayer identification number). See Reg. § 1.671-4(b).

k. **Protector Powers to Afford Flexibility.** To address the concern that a beneficiary might repeatedly actually imprudently exercise the withdrawal power, a protector could have the ability to eliminate the withdrawal power going forward (similar to the provision allowing a donor to the trust to provide that a Crummey withdrawal power would not apply as to particular future gifts to the trust).

l. **Advantage of BDOT Provisions With Trust Planning Under PLR 201633021.** If an existing trust (T1) is not exempt from the GST tax, one planning approach would be for someone (likely the same donor) to create a new trust (T2) that would be almost identical to T1 and that would give the existing non-exempt T1 the ability to withdraw an amount equal to the entire taxable income (including capital gains) from the assets of T2. GST exemption would be allocated to T2. T2 would be funded with enough assets to justify a substantial purchase of assets (i.e., within the “10% equity folklore safe harbor”). T1 might subsequently sell appreciating assets to T2 in return for a fixed relatively low-interest note, to (hopefully) shift value to the exempt T2 over time. The sale would not be a recognition event because T1 would be the deemed owner of T2 under §678. PLR 201633021 (indeed, under the facts of that ruling, T1 only had the power to withdraw taxable income including capital gains income from T2). If T1 had the power to withdraw all of the assets from T2 and did not do so, query whether that would be treated as some type of contribution to the exempt T2 requiring GST exemption allocation to prevent T2 from becoming partially non-exempt. That potential GST exemption allocation issue does not exist if T1's withdrawal power is limited to the taxable income and if the trust has a hanging

withdrawal power so that all such withdrawal powers can be lapsed out within the 5 or 5 amounts. In that manner, T1 would never be treated as having made a transfer to T2, thus not raising the issue of a “transferor” allocating GST exemption. See Reg. §26.2652-1(a)(5)Ex.5 (lapse of withdrawal right not exceeding 5 or 5 amount not treated as a transfer to the trust; original settlor is still treated as the transferor to the trust).

- m. **Potential Concerns with BDIT Transaction.** A number of IRS private letter rulings treat the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under §678(a)(1) while the power exists and under § 678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust. See e.g. Ltr. Ruls. 201039010, 200949012, 200147044, 200104005, 200022035, 200011058, 200011054 through 200011056, 199942037, & 199935046. Even so, potential technical concerns may arise with BDITs. See generally Luke T. Tashjian, *The Use of Beneficiary Defective Trusts in Modern Estate Planning*, 48 REAL PROP., TRUST AND EST. L.J. 353 (Fall 2013).

The BDIT transaction is not on the Treasury Priority Guidance Plan, but the IRS has expressed concern with the “BDIT” in two ways. The IRS added the “sale to a BDIT” transaction to its “no-ruling” list for the first time in 2013. Rev. Proc. 2013-3, 2013-1 I.R.B. 113, §4.01 (43, 48-52) (no rulings as to §§678, 2035, 2036, 2037, 2038, and 2042). In addition, the sale to grantor trust legislative proposal that was included in prior administration budget proposals specifically refers to the “deemed owner under the grantor trust rules,” which undoubtedly is a reference to trusts treated as being owned by the beneficiary under §678. This is the IRS’s “shot across the bow” suggesting that the IRS is questioning the BDIT concept, though not expressing reasons why it does not work. A particular focus of the IRS will be to determine how a trust goes from having a value of \$5,000 from an initial trust contribution to having a value of millions of dollars through highly leveraged transactions.

For a more complete discussion of the BDIT transaction, see Item 31 of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

16. Conversion of CLAT to Grantor Trust, PLRs 201730012, 201730017, and 201730018

In PLRs 201730012, 201730017, and 201730018, a CLAT was amended to give the grantor’s brother a substitution power. One of the ruling requests is whether the conversion of the trust from a nongrantor trust to a grantor trust (assuming the substitution power is found to be held in a non-fiduciary capacity) is a taxable transfer from the trust to the grantor. The ruling concluded that the conversion from nongrantor trust to grantor trust status is not a taxable transfer for income tax purposes. The ruling observed that Rev. Rul. 85-13, 1985-1 C.B. 184 involved the conversion of a nongrantor trust to a grantor trust (by the grantor’s acquisition of trust assets in return for a note from the grantor, which the ruling viewed as an indirect borrowing of the trust corpus by the grantor). Rev. Rul. 85-13 concluded that the transfer was not a sale for income tax purposes and the grantor did not acquire a cost basis in the assets. This ruling is consistent with CCA 200923024 which similarly concluded (in a ruling involving an abusive transaction) that the conversion of a nongrantor trust to a grantor trust was not a taxable

transaction, noting that treating the conversion as a taxable transaction would have an impact on non-abusive transactions.

The PLRs also concluded that the conversion is not an act of self-dealing under the private foundation rules because the grantor's brother (who held the substitution power) is not a disqualified person under §4946(a). In addition, the trust was not entitled to a charitable deduction because the conversion was not recognized as a transfer at all for income tax purposes.

17. New Procedure for Release of Special Automatic Estate Tax Lien

Prior to June 1, 2016, obtaining a discharge of the automatic estate tax lien under §6324(a) was fairly straightforward; the lien would typically be released with 10 days of sending the Form 4422 to the IRS (or hand delivering it to a local IRS estate and gift tax office). Significant changes in the procedures for estate tax lien discharges were instituted beginning June 1, 2016. The IRS Collections Advisory Group is now handling applications for certificate of discharge of property subject to the estate tax lien; these were formerly handled by the local IRS Estate and Gift Tax Groups. Under the new procedures all sale proceeds must be paid to the IRS or placed in escrow. The only permitted reductions seem to be for amounts needed to satisfy mortgages and "reasonable" selling expenses.

The IRS has issued a revised Form 4422, Application for Certificate Discharging Property Subject to Estate Tax Lien, which must be submitted to the IRS along with the supporting documents described in the instructions to Form 4422.

An internal memorandum dated April 5, 2017, entitled "Memorandum for Director Specialty Collection, Offers, Liens & Advisory - Director Special Examination Estate & Gift Tax" describes some relaxation of the situations in which the lien waiver would be granted including if the estate is not required to file an estate tax return, if the estate appears to be non-taxable, if full estimated tax was paid with an extension request or with the estate tax return, or if the remaining property subject to the lien has a value at least double the unsatisfied amount of estate tax. The memorandum anticipates "that this or similar guidance will be incorporated into the [Internal Revenue Manual]." The IRS may issue a revised Form 4422 with revised instructions.

The revised procedures are useful, but problems will remain. Timing is a serious concern because real estate transactions are time-sensitive.

Planning Tip: For older clients who anticipate that real estate will be sold after their deaths to pay administration expenses or state taxes, consider contributing the real estate into a single member LLC prior to death. The estate tax lien applies to the membership interest in the LLC, not to the underlying real estate.

For further discussion of the special automatic estate tax lien and the new procedures for release of the lien (including a more extended discussion of the relief measures announced in the April 5, 2017 memorandum), see Item 26 of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at www.Bessemer.com/Advisor.

18. Tax Affecting S Corporation Earnings in Valuing S Corporation Stock

Cases have generally not allowed “tax affecting” the earnings of S corporations that are valued based on earnings in light of the fact that the earnings are taxed to the shareholders. The seminal case was *Gross v. Commissioner*, 272 F.3d 333 (6th Cir. 2001), *aff’g*, T.C. Memo 1999-254 (court concluded that the IRS’s expert used a “preshareholder-tax discount rate,” so there was no necessity of “tax affecting” the earnings). Various cases have followed the *Gross* in not allowing tax affecting. *E.g.*, *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, *modified by* T.C. Memo. 2011-244 (LLC taxed as S corporation; “we will not impose an unjustified fictitious corporate rate burden on PMG’s future earnings”).

A case that has been tried in the Tax Court and is awaiting decision will address tax affecting for S corporation stock. *Estate of William Cecil v. Commissioner*, Cause Nos. 14639-14 and 14640-14 (trial held February 2016). In *Cecil*, both the taxpayer AND the IRS’s expert used tax affecting in their analysis. Planners are very interested to see what the Tax Court does with these analyses in light of its firm consistent stance about tax affecting since its 1999 *Gross* case.

19. Selected Business Planning Issues

- a. **Selection of Entity and Business Restructuring Issues Under 2017 Tax Act.** The 2017 Tax Act raises new factors in the selection of entity decision for businesses and may lead to business restructuring efforts to make maximum use of the new §199A deduction for qualified business income. See Item 3.n above.
- b. **An Advantage for C Corporations – Qualified Small Business Stock.** Only C corporations can have qualified small business stock. Section 1202(a)(1) (as modified by §1202(a)(4)) generally excludes 100% of the gain (up to \$10 million or 10 times the amount of cash plus the fair market value of property contributed to the corporation in exchange for the stock) for qualified small business stock acquired after September 28, 2010 held at least five years. (Qualified small business stock is stock in a domestic C corporation originally issued after August 10, 1993 in the stock was acquired by the shareholder as compensation or in exchange for money or other non-stock property, but only if the corporation is a qualified small business, generally requiring that the company has had aggregate gross assets of \$50 million or less at all times after August 10, 1993 and before the time immediately after the stock’s date of issuance, §1202(d)(1).) Particularly for a start-up company trying to attract angel investors, who will typically want to sell their stock after the business becomes successful, this can be a huge advantage. Traditionally, the disadvantage of the 35% top corporate rate, when combined with the double tax on dividends was a serious counterbalance to the advantage of the qualified small business stock opportunity. The permanent reduction of the corporate rate to 21% has decreased much of that disadvantage.

The elimination of §1031 like-kind exchanges for property other than real property does not impact the like-kind exchange of qualified small business stock (within 60 days) that is allowed under §1045(a).

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- c. **Changed Paradigm of Payment of Wages for C Corporation Employee-Shareholders.** Traditionally, the paradigm has been to prefer paying wages (deductible to the corporation) rather than dividends to employees who are also shareholders. But the 21% corporate rate has changed that. If profits are distributed as dividends rather than as wages, the tax for the C corporation is 21% to the corporation plus 20% [the rate on qualified dividends] times the remaining 79% to the shareholder on the dividend, or a total of 37%. (This ignores the 3.8% net investment income tax that would apply for taxpayers who have over \$200,000 [single]/\$250,000 [joint] of taxable income.) But the wages, unlike dividends, would ALSO be subject to employment taxes.

An advantage still exists for the corporation to pay interest to creditor-shareholders (the limit on deducting interest by corporations under the 2017 Tax Act applies only for very high income corporations) or to pay rent to landlord-shareholders.

- d. **Most Popular Types of Partnerships.** Of the 3.46 million total income tax returns by all entities that qualified as partnerships, 65% of them are LLCs, which is clearly the dominant form of the partnership model that is used, terms of numbers of entities. The percentage of returns filed for the remaining entities taxed as partnerships are: general partnerships (16%); limited partnerships (14%); and limited liability partnerships (5%).
- e. **Traditional Advantages of Partnerships Over S Corporations.** Partnerships have two primary tax advantages over S corporations. First, partners have great flexibility in allocating income, even after the end of the taxable year, as long as the allocation has economic reality and is not just an allocation for tax purposes, whereas income must be allocated pro rata to all shareholders of an S corporation. Second, for a partnership that has made a §754 election, at the death of a partnership, the basis adjustment in the deceased partner's partnership interest results in an adjustment under §743 of the inside basis of the partnership assets with respect to persons inheriting the deceased partner's interest. That inside basis adjustment does not apply to any other type of entity (C corporation or S corporation).
- f. **Estate Planning Issues for New Business Venture.** The creation of any business venture is an excellent time for transfer planning, because of the potential huge appreciation opportunity. Some planners prefer using a three-layer system. (1) A client and irrevocable grantor trust invest in (2) a family LLC, and (3) the LLC invests in a separate entity that owns the new operating business. Advantages are: (1) the LLC is transparent from income tax standpoint as a disregarded entity; (2) control can be separated from equity ownership at the family LLC level whereas partners and investors in the business level may not want to have voting and nonvoting interests; (3) the activities of the family LLC are private vis-à-vis other owners of the operating business; and (4) the family LLC is available to invest in other businesses in the future.

Tax issues that may arise with this arrangement include the following.

- (1) **Guarantees.** The IRS sometimes raises issues about the tax treatment of parents guaranteeing a child's loan, and whether that is treated as a gift. However, if the parent guarantees a loan to the operating business as one of the primary owners,

that appears as a very traditional business arrangement of principals (rather than third party investors) guaranteeing business loans.

(2) **Compensation.** Reasonable compensation must be paid to family members for services rendered.

(3) **Valuation.** Some clients will take the position that the new business venture has no value at start-up. (The planner may respond by offering to buy a 50% interest in the business for \$1,000 if the client really thinks that it has no value.)

- g. **Transfer Planning Shortly Before a Sale.** A fairly common situation is the client who inquires about transfer planning after having already received a “term sheet” for the sale of the business. If the “ink is not yet on the pages,” discounts might still be available. The following article summarizes how to analyze the valuation issue. Radd L. Riebe, *Discounts Before The Deal Is Done*, TRUSTS & ESTATES, at 37 (December 2007). The author suggests the following approach: (1) determine the present value of future payouts under the proposed sale transaction; (2) analyze the expected value of the stock if the sale is consummated and if it isn’t, with the non-transactions scenario examining risk factors such as due diligence issues, representations and warranties, and financing contingencies that may sink the deal, to estimate a probability weighted expected value for the deal; and (3) subtract an arbitrage discount to reflect the risk that the two potential outcomes have significantly different results for the hypothetical buyer.
- h. **Prenuptial Agreement to Address Family Business Interest.** Prenuptial agreements are invariably very sensitive documents. The agreement may be much more acceptable if it just deals with the business interest (the family legacy asset) rather than purporting to deal with all marital assets.
- i. **Unhappy Family Member Wanting Out of the Business.** The situation of an unhappy family member or family branch that wants to be bought out of the business always hoists tense negotiations into the family relationships. The situation may be resolved much more easily among family members if family meetings beginning when the children came of age dealt not only with the business issues, but also valuation issues – how a business is valued, why discounts apply, what it means to be involved in a business and take additional risks, and the effects of not being in the business to avoid that risk but then holding potentially lower reward assets. These valuation concepts are much better received in early general educational meetings rather than when being first heard in the context of wanting to be bought out.

20. Roth IRA Selected Issues

- a. **Beneficiary Selection for Roth IRA.** The best beneficiary designation for a Roth IRA is outright to the surviving spouse. The surviving spouse can rollover the IRA to the spouse’s own Roth IRA, and will not have to begin taking distributions at any time during balance of the spouse’s lifetime. At the spouse’s death, a beneficiary (preferably a young beneficiary) can be named and the payout would be made over that beneficiary’s life expectancy. A terrible choice of beneficiary is a charity, because the Roth IRA affords tax-free benefits and the charity would get no tax benefits from the Roth IRA. Another poor choice is a trust for the surviving spouse, because the benefits would have to be paid out over the life expectancy of the spouse.

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- b. **Conversion to Roth IRA IS a Way of Taking Advantage of Losses That Would Disappear at Owner's Death.** Various carryforwards (such as the charitable contribution carryforward or the loss carryforward) vanish if they are not used during the person's lifetime or on his final income tax return. An excellent way to make use of a carryforward deduction that will otherwise vanish at death is to convert an IRA to a Roth IRA before the time of death. The conversion causes income recognition, which would be offset by the carryforward.

21. Tax Effects of Settlements and Modifications

The tax effects of court modifications, other trust modifications, decanting, and settlements are summarized in Items 42-51 of the ACTEC 2015 Annual Meeting Musings summary found [here](#) and available at www.Bessemer.com/Advisor. This Item includes several brief miscellaneous comments.

- a. **Background; *Bosch and Ahmanson*.** In *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967) the Supreme Court observed that legislative history regarding the marital deduction directed that "proper regard" be given to state court construction of wills. Because the Senate stated "proper regard" rather than "final effect," the opinion concluded that state court decisions should not be binding on the issue, and that federal courts in tax cases will be bound only by the state's highest court in the matter before it.

The *Bosch* approach is applied to settlements in *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). A four-part test is used to determine if the results of a settlement will govern the tax consequences.

Effectively, the IRS seems to be taking the position that a "settlement tax" exists. The IRS is more inclined to give consideration to a court judgment, but totally ignore settlements because they are viewed as collusive transfers. The courts and national office of the IRS typically realize that the four-part analysis applies, but individual examiners are extremely suspicious of collusion in settlements.

- b. **Revenue Ruling 73-142—Pre-Transaction Actions Can Avoid *Bosch* Analysis.** In Rev. Rul. 73-142, a Settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§2036 or 2038 if held by the grantor *at his death*. The Settlor obtained a local court construction that the Settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the Settlor removed the trustee and appointed another, so the Settlor no longer had the removal power. In Revenue Ruling 73-142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred *before the taxing event*, which would have been the Settlor's death. The IRS agreed that it was bound by the court's ruling as well:

In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, *regardless of how erroneous the court's application of the state law may have been*. Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have

brought the value of the trust corpus within the provisions of sections 2036 and 2038 of the Code were thus effectively cut off before his death.

Unlike the situation in *Bosch*, the decree in this case was handed down *before the time of the event giving rise to the tax* (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such *date since the decree, in and of itself, effectively extinguished the power*. In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter. Rev. Rul. 73-142, 1973-1 C.B. 405 (emphasis added).

Get the construction proceeding final order before the taxing event, and the IRS will be bound under Revenue Ruling 73-142. But the prior court order must be obtained *prior to* the event that would otherwise have been a taxable event.

PLRs 201723002 and 201723003 are examples of situations in which this opportunity should apply. The taxpayer reformed his irrevocable trust in a state court action to remove powers that were reserved to the grantor as a result of a scrivener's error, and the reformation was completed before the taxpayer died, which avoided estate inclusion under §§2035,2036, or 2038. The rulings reasoned that the reformation to correct the scrivener's error was consistent with state law under the *Bosch* doctrine, but the result should have been the same even without the *Bosch* analysis.

- c. **Construction vs. Reformation/Modification Proceedings.** A construction proceeding interprets a document as signed. It often involves an ambiguous document. The IRS is essentially bound regarding the availability of a marital or charitable deduction, because the interpretation relates back to the date of execution of the instrument (assuming the four-part analysis of settlement agreements can be satisfied).

A reformation modifies a document, and the IRS position is that the reformation generally applies prospectively only. Accordingly, a post-death reformation may not result in an action causing assets to have passed to a surviving spouse or charity as of the date of death to qualify for an estate tax marital or charitable deduction. Some rulings have given reformations retroactive effect, however, in "unique circumstances." *E.g.*, PLR 201807001 (donor intended trust to be a grantor trust, which it was at the time of creation, but §672(f)(1) retroactively caused trust not to qualify as grantor trust; reformation "taken into account" as of date of trust creation). See Item 21.d below.

Planners may be creative in finding an ambiguity that can be used in a construction proceeding, rather than using a reformation/modification proceeding, in light of the more favorable tax treatment resulting from construction actions. In *Hubble Trust v. Commissioner*, T.C. Summ. Op. 2016-67, a trust instrument gave the trustee the authority to use and distribute "[a]ll unused income and remainder of the principal ... as will make such uses and distributions exempt from Ohio inheritance and Federal estate taxes and for no other purpose." The local court entered an order that the trust was ambiguous and that it authorized the trustees to make charitable distributions. The Tax Court agreed with the IRS that no latent ambiguity existed that could be construed by the probate court (even though the drafting attorney believed that the trustees were supposed to be authorized to make charitable distributions), and that distributions did not qualify for an income tax charitable deduction.

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- d. **Recent Rulings Regarding Tax Effects of Court Modifications.** A 2016 Chief Counsel Advice refused to give effect to a court modification for purposes of whether or not charitable distributions were made “pursuant to the terms of the governing instrument.” CCA 201651013. The trust was modified to give the beneficiary a limited power of appointment in favor of charity. The IRS concluded that if the beneficiary exercised a power of appointment to make distributions to charity, a charitable deduction would not be available under §642(c) because the distribution would not be made pursuant to the terms of the governing instrument.

A recent Chief Counsel Advice similarly concluded that assets appointed to charities under a power of appointment granted in a court modification would not satisfy the “pursuant to the terms of the governing instrument” requirement. CCA 201747005 (includes extended discussion of Bosch and Rev. Rul. 73-142). This conclusion seems incorrect; if the governing instrument is effectively modified under state law before the transfer to charity, subsequent transfers would seem to be made pursuant to the terms of the governing instrument in the absence of guidance under §642(c) that it looks only to the governing instrument as drafted, without valid modifications.

A 2018 private letter ruling gave retroactive effect to a trust reformation. The trust was intended to be a grantor trust, and it was a grantor trust when created and funded. However, §672(f)(1) retroactively caused the trust no longer to be a grantor trust. It provides that the grantor trust rules do not apply except to the extent they cause a citizen or resident of the United States to be the deemed owner (and the grantor was not a United States citizen or resident), but an exception described in §672(f)(2)(A)(ii) states that the grantor trust rules can apply if only the grantor or grantor’s spouse can receive distributions. The trust included the grantor’s issue as beneficiaries (as well as the grantor), so the exception did not apply. That statute was passed after the trust had been funded, but it was retroactive to a date that was before the funding date. Based on the grantor’s intent, the retroactive law change, and the fact that no distributions had been made, a reformation removing the grantor’s issue as potential beneficiaries was given effect as of the date of the creation of the trust for the purpose of determining that the trust falls within the §672(f)(2)(A)(ii) exception. PLR 201807001.

22. State Income Taxation of Trusts

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

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

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

For a very complete survey of the nexus rules in the various states, see the Bloomberg BNA Special Multistate Tax Report, 2017 Trust Nexus Survey, available at <http://src.bna.com/tBG> (published October 2017).

- b. **Significance.** This issue is arising more frequently as (1) states are strapped for revenue and are getting more aggressive, and (2) beneficiaries and individual trustees are more mobile, which may have the effect of changing the tax situs. Beware of naming family members as trustee without considering whether the appointment could cause the trust to be subject to income tax in the state of the trustee's residence. These issues are exacerbated by the trend of splitting up trustee functions among co-trustees, increasing the possible likelihood of having at least one co-trustee in a state that uses the trustee's residence as a basis for taxing trusts.

- c. **Recent Trend of Cases Rejecting Constitutionality of State Trust Taxation Approaches.** Recent cases have held or suggested that Illinois, New Jersey, North Carolina, and Pennsylvania could not tax trusts merely because the settlor was a resident of those states when the trust was created. *E.g.*, *Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 789 S.E.2d 645 (N.C. App. 2016), *aff'g*, 12 CVS 8740 (N.C. 2015) (now on appeal to North Carolina Supreme Court); *Residuary Trust A u/w/o Kassner v. Director, Division of Taxation*, 2015 N.J. Tax LEXIS 11, 2015 WL 2458024 (N.J. Sup. Ct. App. 2015), *aff'g*, 27 N.J. Tax 68 (N.J. Tax Ct. 2013); *Linn v. Dep't of Revenue*, 2013 IL App (4th) 121055 (2013); *McNeil v. Commonwealth of Pennsylvania*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (2013). For further discussion about the details of each of these cases see Item 22.a of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and Item 17.c of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at www.Bessemer.com/Advisor.

Minnesota is the latest state to join this trend. In *William Fielding, Trustee of the Reid and Ann MacDonald Irrevocable GST Trust for Maria V. MacDonald, et al., v. Commissioner of Revenue*, (Minn. Tax Ct. May 31, 2017), the court addressed the Minnesota statute providing that an inter vivos trust is treated as a resident trust if the grantor was a Minnesota resident when the trust became irrevocable. The taxpayer paid income tax on all income earned by the trust in 2014, but filed a claim for refund, alleging that Minnesota's taxation of non-Minnesota income merely on the basis of the grantor being domiciled in Minnesota when the trust became irrevocable was unconstitutional, violating the due process clauses of the Minnesota and U.S. constitutions, and the Commerce Clause of the U.S. Constitution. The Commissioner tried to point to other (rather minimal) contacts with Minnesota, but the court concluded that the only factor that was relevant for consideration was the statute's description of the grantor's domicile when the inter vivos trust became irrevocable and whether that basis was sufficient on constitutional grounds. The court concluded that

the grantor-domicile sole basis under the Minnesota statute for treating an inter vivos trust as a Minnesota resident trust violated the due process provisions of the Minnesota and United States constitutions. Minnesota was not entitled to tax the income from the sale of stock (of a Minnesota corporation) or income from an out of state investment account. The case is on appeal to the Minnesota Supreme Court.

Another recent relevant case is *T. Ryan Legg Irrevocable Trust v. Testa*, 75 N.E.3d 184 (Ohio 2016), *writ cert. denied*, 2017 U.S. LEXIS 5567 (U.S. 2017). The Ohio Supreme Court upheld imposition of Ohio income tax on a nonresident Delaware trust's sale of Ohio S corporation interests, based on a state statute requiring that nonresidents pay Ohio income tax on taxable gains from the sale of a 20% or greater interest in an Ohio pass-through entity. An earlier Ohio case held that statute was unconstitutional as applied to a seller that had not availed himself of Ohio's protections and benefits in a direct way. The Ohio Supreme Court nevertheless upheld the imposition of the Ohio tax in this case, even though the Delaware trust had not availed itself of Ohio protections and benefits, because the trust's settlor was from Ohio and that same person was the original founder and manager of the pass-through entity (though he had withdrawn from the business before the year in question). The taxpayer petitioned the U.S. Supreme Court for a writ of *certiorari*, partly on the basis that the trust itself had no Ohio beneficiaries and was not involved in the company's business and the trust had no contacts with Ohio other than the settlor being from Ohio. Dana Fitzsimons (Atlanta, Georgia) reports that the taxpayer's brief to the Supreme Court is an outstanding review of the history of cases that have addressed the constitutional issues of taxing nonresident trusts based on the settlor's residency.

23. Purchase of GRAT Remainder Interest Did Not Work

Chief Counsel Advice 201745012 involved a deathbed purchase a remainder from a GRAT. The day before he died, the grantor purchased the remainder from two GRATs with two unsecured promissory notes. The IRS, emphasizing the deathbed nature of the transaction, held that the IRS would completely disregard the remainders as consideration for the purchase, because the remainders would have been included in the grantor's estate in any event, and purchasing the remainders did not change that. Therefore, the grantor was treated as receiving no consideration, so the transfer of the notes was treated as a completed gift. (The IRS reached a similar result in Rev. Rul. 98-8, in the context of §§2519 and 2044 for a marital trust.) The Chief Counsel also concluded that the notes are not deductible by the estate. In effect, this technique resulted in a phantom net addition to the estate. A gift was made, using applicable exclusion amount, and the decedent owned the remainder interest, but no offsetting deduction was available for the decedent's estate.

24. Exercise of Substitution Power

Exercising a nonfiduciary power to substitute assets has proved to be no cakewalk, particularly when notes are tendered for the substitution. Three cases have addressed the attempted exercise of substitution powers by giving notes. In two cases the substitution was not effective, *Condiotti* and *Schinazi*, and in one case the court refused to grant summary judgment finding the transaction ineffective, *Benson*.

In re The Mark Vance Condiotti Irrevocable GST Trust, No. 14CA0969 (unpublished opinion Col. App. 2015) held that the attempt to exercise a substitution power by offering an

unsecured note for a trust asset held ineffective, reasoning that the proposed transaction was an attempt to borrow from the trust, not to substitute assets, so that the trustees could properly reject it. *Schinazi v. Eden*, 729 S.E. 2d 94 (Ga. Ct. App. 2016) involved an attempt to substitute a note for a limited partnership interest that owned valuable pharmaceutical patents. The attempt failed because the note was not equivalent value (some evidence indicated that the value of the partnership interest increased just days after the tender), and the grantor failed to follow the necessary steps under the partnership agreement to complete the acquisition.

The grantor may have been more successful in *Benson v. Rosenthal*, 2016 WL 2855456 (E.D. La. 2016) (slip copy), *mot. for partial summary judgment denied*, 2016 WL 6649199 (E.D. La. 2016). The court refused to grant summary judgement treating proffer of note as ineffective, observing that (1) the trust agreements did not explicitly exclude a promissory note from being used to exercise the substitution power, (2) the notes were assets having value, and (3) the real estate and loan forgiveness that the grantor offered as part of the substitution were further proof that a loan was not intended.

For an interesting discussion of practical problems that arise in implementing and exercising swap powers, see Martin Shenkman & Bruce Steiner, *Swap Powers-Consider Some Often Overlooked Practical and Technical Aspects*, *Trusts & Estates* 45 (Dec. 2015).

An alternative that would avoid the issue of whether the substitution power could be exercised by a note would be for the grantor to borrow funds from a bank and transfer cash in exchange for the substitution. That would also avoid the possibility of the trust being treated as holding a note with no (or minimal) basis.

25. Garnishment Defeats Spendthrift Protection

Spendthrift protection may merely preclude acceleration of a beneficial interest, not attachment of distributions once the beneficiary becomes entitled to them. A proper garnishment order may be applied to enforce a creditor's right to distributions as they are made, essentially mandating the trustee pay directly to the creditor anything that is immediately distributable to the beneficiary. Section 502 (c) of the Uniform Trust Code provides otherwise, but various cases have allowed garnishment actions against spendthrift trusts. *E.g.*, *United States v. Harris*, 854 F.3d 1053 (9th Cir. 2017)(citing 28 U.S.C. §3002(12), garnishment under federal law may reach "property," which includes "any present or future interest, whether legal or equitable;" a beneficiary's right to receive discretionary payments from a spendthrift trust was treated as "property" under the statute, and therefore subject to garnishment); *Carmack v. Reynolds*, 391 P.3d 625 (Cal. 2017) (bankruptcy trustee entitled to reach a sum up to the full amount of distributions that are currently due and payable to beneficiary from spendthrift trust).

26. Recurring Elder Abuse Issues

- a. **Standing to Receive Information and Sue Regarding Revocable Trusts.** The traditional rule for a revocable trust is that while the settlor is alive, all right of beneficiaries other than the settlor are subject to the settlor's control, and the trustee's duties run exclusively to the settlor. UNIF. TRUST CODE §603(a). The trustee has no duty to inform or report to beneficiaries other than the settlor of a revocable trust while the settlor is still alive. *Id.* cmt. A practical concern is that this limits the

ability to seek redress for perceived abuses by a trustee before the settlor's death, often by one heir as trustee.

This is a troubling issue with strong competing policies of (1) right to autonomy of the individual vs. (2) protecting against overreach by a future greedy heir. Stated differently, (1) the plaintiff will just use the information to "shake down momma" vs. (2) no one is "keeping an eye on the fox in the henhouse."

Approaches that have developed in the cases are (1) remainder beneficiaries have no right to complain at any time about activities during the settlor's life (the traditional rule), and (2) the remainder beneficiaries' right to information or to sue is delayed until after the settlor's life (so as not to interfere with the settlor's autonomy during his or her lifetime). Cases in the second category have generally been very egregious cases.

Bucking this trend of cases and the traditional rule is *Rhea Brody Living Trust v. Deutchman*, 2017 Mich. App. LEXIS 1430 (2017). The settlor's daughter was allowed to sue the trustee of her mother's revocable trust (the trustee was the mother's husband) even though the mother had not been declared incompetent. The court specifically said that it was unnecessary to determine whether the settlor was disabled under the trust terms or whether the trust is revocable to resolve the issue as to the daughter's standing. The court found that the trustee had breached his fiduciary duty and removed him as trustee.

What should a planner do in light of this difficult issue? Ask the client to explore which of the strong policies the client wishes to protect – the rights to this own autonomy or to be protected against potential abuse. (A practical difficulty is that the document is sometimes being prepared at the request of the abuser, or potential abuser.)

- b. **Actions Under Power of Attorney.** In *Hauser v. Hauser*, 796 S.E.2d 391 (N.C. Ct. App. 2017), the court refused to allow a daughter to obtain an accounting from her brother as agent under a power of attorney for her mother, or to pursue allegations of intentional interference with an expected inheritance. The court reasoned that "[w]hile Mrs. Hauser remains living, any claim arising out of a fiduciary relationship between her and Defendants can only be brought by Mrs. Hauser herself or someone legally authorized on her behalf."

The Uniform Power of Attorney Act provides more ability to compel information or to review an agent's conduct, even during the principal's lifetime. UNIF. POWER OF ATTY. ACT §116(a). The comment begins: "The primary purpose of this section is to protect vulnerable or incapacitated principals against financial abuse. Subsection (a) sets forth broad categories of persons who have standing to petition the court for construction of the power of attorney or review of the agent's conduct, including in the list a "person that demonstrates sufficient interest in the principal's welfare."

- c. **Power of Attorney Abuse.** Setting aside fraudulent actions under powers of attorney present another case of competing policies: 1) facilitating efficient use of powers of attorney by protecting third persons relying on them, and 2) protecting innocent third-party purchasers VERSUS protecting the innocent defrauded principal- especially where the power of attorney was forged (in a period of heightened sensitivities about elder abuse). The Uniform Power of Attorney Act §119 and a variety of state statutes encourage third persons to rely on actions taken under a

power of attorney. Among other things, these statutes require that the power of attorney be acknowledged. *Yi v. Oh*, 2017 WL 3393283 (Cal. Ct. App.) did not protect a third party who acted in reliance on a forged power of attorney. A Comment to the Uniform Power of Attorney Act specifically says that a third party is protected rather than the principal even if the power of attorney is forged, as long as the person “in good faith accepts an acknowledged power of attorney without knowledge that it contains a forged signature or a latent defect in the acknowledgement.”

27. Developments Regarding Fiduciary Access to Digital Assets.

- a. **Lawful Consent by Personal Representative of Deceased Owner under Stored Communications Act.** The Stored Communications Act 18 U.S.C. §§2701-2712 creates privacy rights to protect contents of certain electronic files from disclosure by online providers. It prohibits an account provider from disclosing the contents/files of electronic to fiduciaries and family members unless an exception applies. If an exception applies, the service provider MAY voluntarily disclose the contents/files. One exception is if “lawful consent” exists, but the Act does not specifically address whether personal representative of a deceased individual can grant “lawful consent.”

In *Ajemian v. Yahoo, Inc.*, 2017 WL 4583270 (Mass.), the Massachusetts Supreme Judicial Court initiated transfer of the case from court of appeals on its own motion. The court held that that the decedent’s personal representative could provide lawful consent on the deceased user’s behalf to release the contents of the deceased user’s email account. It remanded the question of whether Yahoo’s “terms of service” agreement allows Yahoo to refuse access to the account, but hinted that the 15-page terms of service agreement may be UNENFORCEABLE as a contract of adhesion or because there was no meeting of the minds. A footnote raised possible issues of “consistency with public policy or any putative unconscionability of the terms.”

- b. **Disclosure of Contacts and Calendar under Revised Uniform Fiduciary Access to Digital Assets Act.** Some of the general rules under the Revised Uniform Fiduciary Access to Digital Assets Act (RUFADA) are:

- A fiduciary can obtain full access to digital assets **other than content** of electronic communications unless the user opts out or the court directs otherwise;
- For a fiduciary to access the **content** of electronic communications, the governing document must expressly authorize fiduciary access, or the account holder must otherwise consent to fiduciary access via an online tool;
- If a conflict exists between the online tool/account setting and the estate planning documents, the online tool/account setting prevails (§4(a)) – this was a very important and significant concession by the ULC representatives; and
- Under §16(a), if a custodian fails to comply with a request from the PR of a deceased user’s estate to disclose contents, the PR may apply to state court for an order directing the custodian to comply with the request.

In the Matter of the Estate of Serrano, 2017 NY Slip Op. 27200, 56 Misc.3d 497 (Surr. Ct. NY County 2017) addressed how RUFADA applies to a PR’s request to obtain access to the decedent’s Contacts and Calendar from a Google account. The

court observed that RUFADA requires a disclosure of the catalogue of electronic communications, but not the content without express consent to fiduciary access. The court concluded that the Contacts are within the description of a “catalogue” and therefore must be disclosed. It reasoned that Calendar entries are not a “communication” under the Stored Communications Act because no transfer of information occurs between two or more parties, and that entries in the Calendar are also part of the catalogue, does not contain content of electronic communications, and therefore must be disclosed.

28. Electronic Wills Act

Traditionally, wills must be on paper, either typed (or printed) or handwritten. Nevada was the first state to adopt a statute recognizing electronic wills. NEV. REV. STAT. §133.085(1) (2017). In 2017, legislation was passed that would have allowed persons to execute wills electronically without the physical presence of a witness or an attorney, but Governor Scott vetoed the Florida Electronic Wills Act on June 26, 2017. Legislation allowing electronic wills is pending in Indiana, and is being considered in other states as well. A growing trend of interest is appearing in this topic.

The Joint Editorial Board for the Uniform Trusts and Estates Act has recommended that the Uniform Law Commission form a drafting committee to address proposed uniform legislation governing electronic wills. For an excellent overview of the history of electronic wills, legislative proposals being considered, and policy issues that must be addressed, see Bruce Stone, *Technology and Estate Planning – The Machines Are Coming, Will You Be Ready?*, LEIMBERG ESTATE PLANNING NEWSLETTER #2625 (February 6, 2018).

29. Decanting Authority and Creditor Effects, *Ferri v. Powell-Ferri*

Litigation in Connecticut and Massachusetts addresses the common law ability to decant in Massachusetts and the creditor effects (in a divorce proceeding) of decanting. *Ferri v. Powell-Ferri*, 72 N.E.3d 541 (Mass. 2017) followed the *Morse v. Kraft* [466 Mass. 92 (2013)] approach in finding that the broad discretion granted to trustees regarding distributions as desirable for the beneficiary’s benefit and authority to “segregate irrevocably for later payment to” the beneficiary included by inference the power to decant to a new trust for a beneficiary, and the court could consider the affidavit of the settlor in making the determination of intent to allow a decanting power. The issue had been certified to the Massachusetts high court from the Connecticut Supreme Court in a divorce case.

Under a trust agreement created by his father, the beneficiary had the right to withdraw 75% of the trust assets at the time of the divorce proceeding, but the trustees decanted the trust assets into a new trust that did not grant the beneficiary withdrawal rights, apparently so that the trust assets over which the beneficiary had withdrawal rights would not be included as marital property subject to division in the divorce. The Massachusetts Supreme Judicial Court reasoned that the presently exercisable withdrawal right did not negate the power to decant because the trust must be read as a whole to give effect to all of its provisions. So long as the assets were not withdrawn, the assets remained subject to the trustees’ authority and stewardship, especially in light of the power to segregate

assets irrevocably that extended for “so long as the beneficiary is living” meaning both before and after the vesting of withdrawal rights. Therefore, until assets are actually withdrawn, the trustees could exercise the power to decant if the trustees determined it was in the beneficiary’s best interest. A concurring opinion in the Massachusetts case observed that the opinion did not address whether creating a new spendthrift trust for the sole purpose of decanting assets from an existing non-spendthrift trust to deny the beneficiary’s spouse’s rights to an equitable distribution in a divorce proceeding was contrary to public policy.

The Connecticut Supreme Court then addressed the effect of the authorized decanting in the divorce proceeding. 2017 WL 3386926 (Conn.) It determined that the spouse had standing to question whether the trustee’s actions were proper, but held that the new trust was not a self-settled trust as to the beneficiary, and was not subject to the claims of his creditors. It reasoned that the new trust was created and founded via the decanting by the trustees without informing the beneficiary in advance, and without his permission, knowledge or consent. Because the beneficiary had no involvement in the creation and funding of the new trust, it was not self-settled. A beneficiary could only be deemed to be the settlor of a trust if he has some affirmative involvement with the creation or funding of the trust.

30. Interesting Quotations

- a. **Legislation.** “I refer to the 2017 Tax Act as a poorly conceived, even more poorly executed, steaming pile of covfefe.” — Paul Lee
- b. **Swiss Cuisine.** “Switzerland is one of the most beautiful places on the planet. It is so pretty it looks fake. However, Switzerland has the most unbelievably horrible food you’ve ever eaten. It’s so bad. They eat a lot of horse, and they eat a lot of this really horrible smelly nasty cheese, and they try to divert your attention, and make it seem like it’s more fun and more delicious, by putting it in a fondue pot.” — Amy Kanyuk
- c. **Beneficiaries and Cats.** “Beneficiaries are like cats. They are only happy if you are feeding them.” — Amy Kanyuk
- d. **Beneficiaries and Cats Redux.** “Keep in mind – Beneficiaries are like cats and they will bite you for no good reason.” — Amy Kanyuk
- e. **How Much and When.** “How much and when? That is what trust beneficiaries ask when they call. They want to know how much they’re getting and when are they getting it. And the answers are – not as much as you think and when I’m ready.” — Amy Kanyuk
- f. **Disclaimer.** “As a litigator, what I am about to say and the views I am about to express are not my own, and I reserve the right at any time to change my position and assert the position of the other side. So take what I say with a grain of salt to the extent that this is being recorded.” — William Hennessey
- g. **Trustee’s Mantra.** “The goal of the trustee is not to make the beneficiary happy but to carry out the grantor’s intent.” — Amy Kanyuk

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- h. **Spray Trusts.** Hugh Magill's Rule About Spray Trusts: "If beneficiaries cannot live together in the same household, they should not live together in the same trust." — Hugh Magill
 - i. **Sibling Relationships.** "Nothing will disrupt sibling relationships more quickly or more effectively than one receiving a larger inheritance than the others." — Andrew Pharies
 - j. **Medicare.** "LBJ described Medicare this way: 'Every citizen will be able in his productive years when he is earning to ensure himself against the ravages of illness in his old age. No longer will illness crush and destroy the savings that they have so carefully put away over a lifetime so that they might enjoy dignity in their later years.' If LBJ knew how it has turned out, he would be rolling over in his grave." — Bernard Krooks
 - k. **Favored Lending Institution.** "They never heard of Citibank and Chase. They only heard of the Bank of Mom." — Sam Donaldson
 - l. **Oral Contracts.** "Samuel Goldwyn of Metro Goldwyn Mayer said 'An oral contract isn't worth the paper it isn't written on.'" — Josh Rubenstein
 - m. **Trust Disputes and Family Dynamics.** "We've talked about complicated intellectual stuff all week at Heckerling. So much of this comes down to feelings and communicating. A lot of trust disputes that we see are all about family dynamics going all the way back to childhood. It had nothing to do with money... They were lashing out from when they were kids and how he behaved as a father to them." — Scott Ditman
 - n. **Nuclear Families Fight Also.** "People assume that only blended families fight – where children by the first three marriages are older than the surviving spouse, and the surviving spouse has a name like a weather condition (like Wendy or Misty or Stormy or something like that). But nuclear families don't always love each other either. They are united by someone they all love or sometimes they are united by someone they all fear. So long as the person is competent to retaliate, they all get in line. But as soon as the person dies or becomes incompetent to retaliate, war breaks out." — Josh Rubenstein
 - o. **Transparency – Just Fess Up.** "There's no question in my mind that most family litigation, particularly will and trust contests, have at their base a lack of transparency. If the parents only fessed up that they were treating the children differently, the kids could have an opportunity to get angry at the right person to be angry at – dad or mom. The parents would say 'I hear you but the answer is no.' The problem is, the issue doesn't usually come to light until after mom and dad are dead, or not able to explain anymore, and then the child who is treated better gets the joy of stepping into mom and dad's shoes and everybody is angry at them – only they're really angry at the person who is dead." — Josh Rubenstein
 - p. **Get the Spelling Right.** "Very often, family fights are about principle – 'LE,' not principal – 'AL.' — Josh Rubenstein

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- q. **All About the Process.** “As a fiduciary, you don’t have to end up having been right. You just have to have a process where you made the analysis.” — Josh Rubenstein
 - r. **The Mid-Rich.** “Planning for the mid-rich is very difficult. They are not so poor that they have no estate tax concerns but not so wealthy that they have definite estate tax concerns.” —Jeff Pennell
 - s. **Only Temporary.** “If the Section 199A deduction is the latest crack we can’t do without, Congress may make some of this permanent. But it is now available, like the McRib, for a limited time only.” — Sam Donaldson
 - t. **Wallet v. Ego.** In discussing with clients what level of compensation they must pay from an S corporation to avoid IRS attacks on paying insufficient compensation (to avoid paying employment taxes), Sam Donaldson advises that the only ethical answer is that the client should pay the same salary the client could command from an unrelated employer in that same industry. “It’s wonderful to watch greedy entrepreneurs with an ego have this internal fight. Of course they’re worth millions, but they don’t want to pay themselves millions. So the wallet fights with the ego, and it’s a delight to see to see them twitch.” Sam adds “Perhaps it’s better I’m in academia than to have to work with clients.” — Sam Donaldson
 - u. **2% Does Not Mean 2% In the Code.** The “2-percent” shareholders of S corporations are not entitled to certain perks. “Only in the Code – the Code defines a ‘2-percent shareholder’ as someone who owns more than 2% of the S corporation stock. So if you own 2% of the stock, you are not a 2% shareholder. But if you own 3% of the stock, you’re a 2% shareholder.” — Sam Donaldson
 - v. **The Real Story.** For a partnership that has made a §754 election, at the death of a partner the deceased partner’s interest in the partnership gets a basis adjustment to the estate tax value of the interest, and an adjustment is made under §743 to the inside basis of partnership assets, but that inures only to the benefit of the decedent’s legatees and not the remaining partners. “This adjustment does not inure to the benefit of all partners, so that partners are rooting for the deaths of their partners from a tax perspective. They root for the death of their partners just so they can be the sole surviving partner – and because they never really liked them anyway.” — Sam Donaldson
 - w. **Skinny Trusts.** “The skinniest trust may simply provide that property shall be distributed to the beneficiaries in the trustee’s sole discretion. Saying less rather than more leads to the greatest flexibility. In some respects, skinny is good.” — Diana Zeydel
 - x. **Best Way to Learn.** “We try to learn lessons on how to be a fiduciary or advisor to a fiduciary the best possible way – which of course is through the suffering of other people.” — Dana Fitzsimons
 - y. **Powers of Attorney.** “Powers of attorney are useful and essential planning tools, vastly superior to the alternative of public guardianship, and accurately described as the most effective tool for burglary since the invention of the crowbar.” — Dana Fitzsimons

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- z. **It's All in the Name.** "I fully understand the 'Boy Named Sue' thing –my name is Dana, the translation of which (from BabyNameWizard.com) is 'woman from Denmark.'" — Dana Fitzsimons
- aa. **The Other Side.** "I rarely say something is definitively right or wrong because you see enough, and you realize there's no pancake so thin it doesn't have two sides." — Dana Fitzsimons
- bb. **I Don't Do Taxes.** In a case in which a CRAT was improperly drafted and a court reformation was not timely commenced, the attorney's defense was that "the testator never asked for tax advice, didn't care about paying taxes because he was a patriotic veteran, and he considered his duties connected to the probate, that taxes were outside the scope of his responsibility as counsel for the executor, and even though he carried the estate tax returns to the executor for signature, he was a mere messenger and didn't even read them." Dana continues – "As my old boss, Dennis Belcher would say, 'it's time to call your carrier.'" — Dana Fitzsimons
- cc. **Utopia.** "In an ideal world, all families would be functional, love would never die, marriages would never end, trusts would be flexible, my 16-year-old daughter would never date, tax law would remain stable, and we'd all get a puppy." — Dana Fitzsimons
- dd. **Questionable Analysis.** "Here's what you have to do to understand the questionable analysis in a recent decanting case. You have to take out your eyeglasses, squint your eyes, turn your head to the right, and it's like those paintings that we used to look at. If you looked hard enough and if you had enough whiskey to drink, you could see a space shuttle. It's just like that." — Dana Fitzsimons
- ee. **Trust Advice from the Sage.** Dana was working on a difficult trust matter and mentioned to his colleague Ron Aucutt that he didn't know if anything in the trust agreement covered the issue. "Ron Aucutt, in his Garrison Keillor voice, said 'Well Dana, you don't really know what's in a trust until you shake it a few times and see what falls out of it.'" — Dana Fitzsimons
- ff. **"Ectors."** Dana Fitzsimons coined a new term to refer to directors, selectors, protectors, etc. – He refers to all of them as "Ectors." — Dana Fitzsimons
- gg. **Most Creative Argument of the Year.** In *Gray v. U.S. Department of Treasury*, 2017 Dist. LEXIS 144615 (2017) the taxpayer learned that you cannot defeat an IRS tax levy by declaring yourself to be held in trust, with your yourself as an asset of the trust and as a beneficiary of the trust, with the Treasury Department as the trustee, and then suing the Treasury Department as trustee for breach because they pursued the levy. Dana Fitzsimons observed, "in the South, we would say 'bless your heart.'" — Dana Fitzsimons
- hh. **Who Needs a Lawyer?** A testator's estate plan consisted of a pour-over will and revocable trust. After he had a falling out with his son, Lynn (whose nickname was "Butch"), signed various letters and instruments, and the court upheld three of the four letters as amendments to the trust:

(1) A typed, signed, and dated document included “I LEON BARRENGER DISOWN LYNN BARRENGER HE IS DISOWNED AND REMOVED FROM ANY INHEARATANCE ALSO I DON’T WANT HIM TO ANY MEMORIAL IF THEY HAVE ONE SIGNED.”

(2) A typed but unsigned birthday note to his son, Scott, stated “ALSO SKIPPPING BUTCH, S HEISNT GETTING NO MOREMOOLA FROM ME.” [This note was held not to be a valid trust amendment.]

(3) A partially typed, partially handwritten, and twice signed letter to his daughter, Judy, stated “I AM THINKINGAOUT GETTING AGO CART SO I CAN GO TO THE STORE BY MYSELF” and “I DISENHEARTED BUTCH HE CALLED ME A STUPID IDIOT SO I WILL GIVE HIS SHARE TO THE GANDKIDS AT LEAST IT WON’T BE BUYING HIM BEER.”

(4) A handwritten and signed note to his grandson, Quinn, stated “Butch got his big mouth going and he talked himself right out of the Barrenger trust fund. Now I can leave you & Kaitlyn \$14,000 a year tax free.” — Dana Fitzsimons

- ii. **Jargon and German Cars.** In discussing the difficulty that clients may have in understanding the complex jargon that attorneys can use in describing estate planning alternatives, Charlie Ratner noted that a life insurance agent might explain “what the Representative from Complexity is trying to say is ...,” but observed that “the life insurance agent can sometimes use a little help because his stuff is jargon-laden too. That sounds like a German car – the ‘Jargonladen’.” — Charles Ratner
- jj. **Underperforming Life Insurance Policies.** “The client will often say that a life insurance policy is underperforming – no it isn’t, it was under-described.” — Charles Ratner