Heckerling Musings 2013 and Other Current Developments

The Estate Planner's "Playbook" for 2013 and Going Forward Under the Post-ATRA "New Normal" of Permanent Large Exemptions and Portability

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Introduction

The 47th Annual Philip E. Heckerling Institute on Estate Planning was again held in Orlando during the week of January 14, 2013. I have summarized some of my observations from the week, as well as other observations from various current developments and interesting estate planning issues. My goal is not to provide a general summary of the presentations. The summaries provided on the American Bar Association Real Property, Trust & Estate Law Section website (http://www.americanbar.org/groups/real_property_trust_estate/events_cle/heckerling_reports/heckerling_2013.html) that are prepared by a number of reporters, and coordinated by Joe Hodges, do an excellent job of that. In addition, there are excellent summaries provided by Martin Shenkman on the Leimberg Information Services reports. 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. 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.

A major focus of the Institute was estate planning under the "new normal" of transfer tax certainty, large indexed transfer tax exemptions, and portability provided by the American Taxpayer Relief Act of 2012 (ATRA). This summary focuses on practical planning issues that estate planning professional will be facing in this new environment. Topics include:

- legislative matters and proposals (Items 1-4);
- planning for donors who made 2012 gifts, including compliance details (Items 5-6);
- planning approaches for various categories of clients going forward in light of permanent large indexed exemptions and portability (Item 7-8);
- planning considerations for the new 3.8% Medicare tax on net investment income (Item 9);
- strategies to preserve basis at death (turning some traditional planning on its head) (Item 10-11);
- wealth transfer planning strategies leaving some indirect access for the donor and donor's spouse (Items 12-25);
- other sophisticated wealth transfer planning strategies (including using defined value clauses) (Items 26-34);
- planning considerations for commonly used intra-family loans and notes (Item 35); and
- various other practical planning issues (Items 36-42).

It is hoped that this summary might be a useful "playbook" for planning under the new post-ATRA paradigm of permanent high indexed exemptions, portability, and higher income taxes.

1. American Taxpayer Relief Act of 2012 and "3.8% Medicare Tax"

a. *Summary of Provisions*. The U.S. Senate passed ATRA in the early morning hours of New Year's Day 2013. The bill then went to the House and, after hours of speculation as to whether the House would vote on, amend, or even support the bill, the House approved the bill shortly before midnight. (Ron Aucutt quips that the American Taxpayer Relief Act ***of 2012*** was signed on "December 32, 2013.") The President signed ATRA into law on January 2, 2013.

b. *Transfer Tax Changes*. The following are the highlights of the transfer tax provisions of ATRA.

(1) *Sunsetting the Sunset of the 2001 and 2010 Acts*. The estate, gift and generation-skipping transfer tax provisions of 2012 law remain in effect (including the $5 million indexed estate, gift and GST exemption), with several minor modifications. This is accomplished primarily by "sunsetting" the sunset provisions of the 2001

and 2010 Acts; without any change the estate and gift exemptions would have reverted to $1 million; , and the Obama administration proposed a $3.5 estate and GST exemption; Ron Aucutt quips that the compromise between $1 million and $3.5 million was, of course, $5.0 million).

(2) *Top Marginal Rate of 40%*. The top estate, gift and generation-skipping transfer tax rate is increased from 35% (under the 2012 law) to 40%. This appears to be an obvious compromise between 35%, which applied in 2012, and the Obama administration's proposed rate of 40%, and is roughly the same as the top income tax rate).

(3) *Portability Retained with Technical Revisions*. Portability is made permanent beginning in 2011 and the portability provision is modified to remove any "privity" requirement (thus adopting the "Example 3" position that appeared in the Joint Committee on Taxation Report to the 2010 Act).

(4) *Effective Date*. Other than the portability provision (which applies beginning in 2011), these provisions apply to estates of decedents dying, generation-skipping transfers, and gifts made after December 31, 2012; and

(5) "*Permanent*" *Changes*. Quite importantly, these provisions are adopted "permanently," rather than merely being extended for several years.

c. *Selected Other ATRA Changes*. Several other major highlights of ATRA that may be of interest for estate planning purposes are listed.

(1) *Top Income Tax Rate of 39.6%*. The income tax provisions of the 2001 Act are extended except that the top income tax bracket for individuals is increased to 39.6% for *taxable income* in excess of indexed threshold amounts, which, for 2013, are $450,000 for married individuals filing joint returns, $425,000 for heads of households, and $400,000 for unmarried individuals (other than surviving spouses and heads of households).

(2) *Phase-out of PEP and Pease Limitations*. The phase-out of personal exemptions and itemized deductions (the "PEP" and "Pease" limitations) was reduced under the 2001 Act in steps from 2006-2010 (with a total elimination of the phase-out in 2010, extended by TRA 2010 through 2012). ATRA reinstates the phase-out (as under pre-2001 law) for individuals with *adjusted gross income* in excess of new indexed threshold amounts ($300,000 for a joint return or a surviving spouse, $275,000 for a head of household, and $250,000 for an unmarried individual other than a surviving spouse or head of household)(the indexed threshold amount would have been about $175,000 under the pre-2001 statutory provisions).

(3) *Top Rate of 20% for Capital Gains and Qualified Dividends*. The 2003 Act reduced the maximum rate on most long-term capital gains to 15% and applied the same 15% rate to "qualified dividends." Under ATRA, the rates on qualified dividends and long-term capital gains are adjusted by adding new 15% and 20% brackets (i.e., the top "general" rate is increased to 20% for high income taxpayers to which the 39.6% rates apply). Without this change, all dividends would have been taxed at ordinary income tax rates.

(4) *Alternative Minimum Tax Indexed Exemptions*. Permanent alternative minimum tax relief is enacted by providing revised exemption amounts that are indexed for inflation (there will no longer be the need for the annual "AMT patch");

(5) *State and Local Sales Taxes*. ATRA extends the deduction of state and local general sales taxes through 2013;

(6) *Charitable Distributions from IRAs*. Extending through 2013 the ability to make tax-free distributions from individual retirement plans to charity (for qualified charitable distributions up to public charities [not donor advised funds, supporting organizations or certain private foundations] of up to $100,000 for individuals who have reached age 70 ½); rollovers completed by February 1, 2013 can be treated as if made in 2012; a distribution from the individual retirement plan in December 2012 can be treated as a qualified charitable distribution in 2012 if it is transferred in cash to charity before February 1, 2013;

(7) *Conversion of Traditional Retirement Accounts to Roth Accounts*. Traditional retirement accounts may be converted to Roth accounts (beginning in 2010, distributions from traditional retirement accounts could be contributed directly to an employer-offered Roth account only when the individual separated from service, reached age 59 ½, died or became disabled). ATRA allows the conversion in all circumstances, but it differs from regular Roth conversions because the payment of income taxes on the conversion must come from outside the plan, and there is no ability to recharacterize (i.e., "unconvert") the Roth conversion, so this provision is not as advantageous as converting a regular IRA to a Roth IRA.

(8) *"Permanent" Provisions*. Again, quite importantly, these provisions are adopted "permanently" (other than the sales tax and individual retirement plan charitable rollover provisions which, as noted, apply only through 2013).

d. *Medicare 3.8% Tax on Net Investment Income.* The 3.8% Medicare tax was enacted as part of the Affordable Care and Patient Protection Act (not as a part of ATRA), and becomes effective for the first time in 2013. In addition to the increase in the maximum income tax rate to 39.6% for high income earners (i.e., generally joint filers having *taxable income* more than $450,000 and $400,000 for single filers), a new 3.8% Medicare tax applies beginning in 2013 to net investment income if the *adjusted gross income* (without regard to the foreign earned income exclusion) exceeds $250,000 for joint filers and $200,000 for single individuals. Therefore, the top federal rate on investment income for high earners will be 43.4% (not including state income taxes).

The 3.8% tax on net investment income will also impact trust administration planning. The 3.8% tax applies to the *undistributed* net investment income of trusts in excess of the income level at which the highest trust rate applies ($11,950 for 2013). For further discussion of this issue see Item 9 below.

e. *Major Transfer Tax Changes ATRA Avoided.*

- Return to a $1 million exemption for estate, gift and GST tax.
- Concerns about "clawback" where estate tax exemption is lower than a prior gift exemption are now moot.
- De-unification of the gift exemption with the estate and GST exemptions.
- We will never again have to worry about the "as if it had never been enacted" provision in EGTRAA and TRA 2010 that created so much confusion.
- The loss of portability.

f. *Overview of Selected Statutory Provisions of ATRA.*

(1) *Short Title.* Section 1 of ARTA 2012 says the Act may be cited as the "American Taxpayer Relief Act of 2012." Fortunately, we again have a short acronym for the 2012 legislation compared with "TRUIRJCA" — which is why that 2010 Act is abbreviated above as "TRA 2010").

(2) *"Sunsetting" the Sunset.* The heart of the transfer tax changes in ATRA 2012 are several brief sentences in Section 101 of ATRA 2012 striking the sunset provisions in EGTRRA and TRA 2010.

EGTRRA made significant changes to estate, gift and GST tax law, but provided in Title IX thereof (which consisted of a single section--Section 901), the so-called "sunset" provision, that "All provisions of, and amendments made by, this Act [(EGTRRA)] shall not apply . . . to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010," and that thereafter, the Internal Revenue Code would be applied "as if the provisions and amendments [of EGTRRA] had never been enacted."

TRA 2010, among other provisions, increased the estate, GST ***and gift*** exemptions to $5,000,000, adjusted for inflation after 2011, and brought about "portability" of exemptions beginning in 2011. An important provision in TRA 2010 was to amend the sunset provision in EGTRRA, by providing, in Section 101(a) of TRA 2010, that the "sunset" date in Section 901 of EGTRRA would change from December 31, 2010 to December 31, 20***12***, and all provisions of EGTRRA, as amended by TRA 2010, would apply as if the 2012 sunset date had been included in EGTRRA from the outset. Section 304 of TRA 2010 then provided that the EGTRRA sunset provision (as changed by TRA 2010) would apply to all provisions of TRA 2010 as well, and TRA 2010 would therefore sunset after 2012.

Now, Section 101(a)(1-2) of ATRA amends EGTRRA and TRA 2010 by striking the sunset provisions of both laws, and Section 101(a)(3) of ATRA states that the provisions apply with respect to decedents dying, and gifts and generation skipping transfers occurring, after December 31, 2012, without any further sunset provision or other "built-in" expiration.

Accordingly, all of the beneficial provisions of EGTRRA and TRA 2010 in effect in 2012 have now become "permanent" provisions that will remain in effect into the future, without the need for any further action from Congress (except that the rate has changed from 35% to 40% beginning in 2013 and the portability provision has been clarified). Therefore, unlike the situation that existed starting in 2001, we now know that exemptions will not be reduced, rates will not be further increased, and all of the other helpful provisions of EGTRRA and TRA 2010 will not be lost unless and until Congress is willing to enact new legislation that expressly makes those changes.

(3) *Increase Top Rate From 35% to 40%.* Section 101(c) of ATRA increases the effective estate, gift and GST tax rate from 35% to 40%, by re-introducing the 37% ($500,000 to $750,000), 39% ($750,000-$1,000,000) and 40% (over $1,000,000) tax brackets that were eliminated by TRA 2010. From a practical standpoint, however, since the 37% and 39% rates apply to estates, gifts and GST

transfers that are below the "exemption" level of $5,000,000 (inflation adjusted) the practical result will be that if the tax is imposed, it will be imposed at 40%.

(4) *Technical Correction to Portability Provisions*. The only other change to the estate tax rules brought about by ATRA is a technical correction to the portability rules.

TRA 2010 provided for portability of estate and gift tax exemptions by modifying §2010(c)(2) to define the ***basic*** exclusion amount as the sum of the ***applicable*** exclusion amount and the deceased spouse's unused exclusion amount ("DSUE amount"). The key provision, in determining the amount that could be "ported" to the surviving spouse, is the definition of the DSUE amount. Section 2010(c)(4) defines the "deceased spousal unused exclusion amount" as the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the combined amount of the deceased spouse's taxable estate plus adjusted taxable gifts (described in §2010(c)((4)(B)(ii) as "the amount with respect to which the tentative tax is determined under section §2001(b)(1)"). The second item is the last deceased spouse's remaining unused exemption amount. It was strictly defined as the predeceased spouse's "basic exclusion amount" less the combined amount of taxable estate plus adjusted taxable gifts of the predeceased spouse. This appears to impose a "privity" requirement.

ATRA 2012 changes this reference from "basic exclusion amount" in §2010(c)(4)(B)(ii) to "applicable exclusion amount."

This difference is critical, because an individual's "applicable exclusion amount" includes his or her basic exclusion amount **plus** DSUE amount (in the case of a decedent who is a surviving spouse of a prior decedent who left him or her with a DSUE amount). This adopts the position taken in Example 3 on page 53 of the Joint Committee on Taxation Technical Explanation of TRA 2010.

The Joint Committee on Taxation on March 23, 2011 issued an ERRATA document with a footnote suggesting precisely the technical correction included in ATRA 2012. (The IRS adopted this same position in the temporary and proposed regulations adopted in June 2012, in a rather generous construction of the statutory language of TRA 2010. The technical correction in ATRA 2012 will not have any further impact on the portability temporary and proposed regulations.)

(5) *Highlights of Significant Provisions of EGTRRA That Are Now Permanent*. There were important provisions of EGTRRA (that we now take for granted) that are now permanent, including the following:

- Increasing the GST exemption to be the same as the tax-free amount for estate tax purposes rather than $1 million indexed for inflation from 1997 (subtitle C of EGTRRA);
- Ending the qualified family-owned business interest deduction after 2003 (how soon we have forgotten the "QFOBI" complexities);
- Converting the state death tax credit over several years to a deduction for state death taxes (subtitle D);
- Deemed allocations of GST exemption to lifetime transfers to "GST trusts" (subtitle G);
- Qualified severances of trusts for GST purposes (subtitle G);
- "9100 relief" from late GST exemption elections (subtitle G);

- Expansion of conservation easement rules for estate tax purposes (subtitle F); and
- Increasing the number of allowable shareholders or partners for §6166 purposes from 15 to 45 (subtitle H).

g. *Key Transfer Tax Changes Under ATRA; Paradigm Shift in Planning.* The four key transfer tax changes under ATRA are permanence, indexing, unification, and portability.

Permanence. For more than a decade now, planners have had to deal with the constant uncertainty of the estate tax laws, with the realization that the provisions of the 2001 and 2010 Acts would vanish without further Congressional action. Some planners have used rather complicated formula provisions in wills (depending on future laws) and have employed various measures to inject as much flexibility as possible into estate plans, in light of the constant uncertainty hanging over our heads. At last, we have the benefit of some "permanent" provisions (at least as permanent as anything is in the tax world).

Indexing. The ability to transfer $5,000,000 (inflation indexed) during lifetime or at death will continue. The indexing provision is enormous. There are reports that the final major negotiation over the transfer tax provisions involved whether the exemption would be indexed. (Most of the provisions in ATRA are indexed.) In the past, planners focused on a client's future appreciation, and the fact that with future appreciation, the client's estate would far exceed the estate tax exemption amount. With indexing, the exemption may grow at roughly the same rate as the client's estate.

- Clients who failed to use the entirety of their gift and/or GST exemptions in 2012 still have the opportunity to do so in 2013 and beyond.
- Moreover, clients can expect to acquire additional gift and GST exemptions in each new year. The inflation indexed amount for 2012 was $5,120,000, and the inflation indexed amount for 2013 is increased by another $130,000 to $5,250,000. Long-term, the permanent indexing feature of the exemption may have the most dramatic financial impact of the transfer tax provisions in ATRA 2012.

Unification. There was considerable uncertainty in 2012 as to whether the gift exemption would revert back to $1.0 million or some other amount lower than the estate and GST exemption. Permanently unifying the gift exemption with the high estate and GST exemptions opens up broad transfer planning opportunities on a permanent basis.

Portability. Dennis Belcher wraps up the importance of making portability permanent: "Portability is a game changer."

h. *Differing Thresholds*. Observe that there are three different thresholds (with respect to both categories of income and amounts) under the provisions discussed above.

- The thresholds for the new maximum 39.6% ordinary income tax and 20% capital gains tax rate are $450,000/$400,000 of taxable income.
- The thresholds for the PEP/Pease limitations are $300,000/$250,000 of adjusted gross income.
- The thresholds for the 3.8% Medicare tax are $250,000/$200,000 of adjusted gross income.

The effect of these varying thresholds will create some strange tax rates. For example, the 3.8% net investment income tax (based on AGI) will apply in many cases where the top income tax bracket (based on taxable income) will not, so a large number of taxpayers will be paying 18.8% on dividends and capital gains.

2. Administration's Fiscal Year 2013 Revenue Proposals and Proposal Regarding Qualified Retirement Plans

a. *Overview*. The Treasury on February 13, 2012 released the General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (often referred to as the "Greenbook") to provide the details of the administration's budget proposals. These provisions are significant at this point in light of the three-month extension of the debt ceiling limit, and the upcoming debate and negotiations over the current year budget. ATRA was passed with apparently little consideration to revenue impact (for example, allowing indexing of the AMT exemption levels will have enormous revenue impact). The Congressional Budget Office estimates are that ATRA will result in revenue losses over 10 years of $3.63 trillion. There will be no way to offset that with spending cuts, so presumably Congress will be looking for revenue raisers. However, the revenue that would be raised by the various transfer tax proposals (discussed below) are about $24 billion over 10 years, negligible compared to the $3.63 trillion, so that these provisions may not be on the front burner of revenue raisers that Congress may consider this spring. In any event, a client who is considering implementing any transaction that would be affected by any of these proposals may want to act "sooner rather than later" in case any of these proposals should be enacted this year.

b. *Repeated Items From Years Prior to Fiscal Year 2012 Proposals*.

(1) *Require Consistency in Value for Transfer and Income Tax Purposes*. The basis for income tax purposes would be the same "as determined for estate or gift tax purposes (subject to subsequent adjustments)." The proposal does *not* adopt the approach suggested in a Joint Committee on Taxation report to require that the income tax basis be consistent with values as reported on gift or estate tax returns, even if the transfer tax values were subsequently adjusted on audit.) (Estimated ten-year revenue: $2.014 billion in 2013 Fiscal Year plan.)

That proposal was included in H.R. 3467, The Sensible Estate Tax Act of 2011, sponsored by Rep. Jim McDermott (D-WA). The bill provides that the basis shall not exceed the value "as finally determined for purposes of chapter 11" [or chapter 12 in the similar gift tax provision]. If there has been no final determination, the basis shall not exceed the amount reported on a basis information statement that will be required under §6035 to be given to estate or gift recipients where estate or gift tax returns are required under §6018.

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

(2) *Modify Rules on Valuation Discounts*. The proposal would revise §2704 to add an additional category of applicable restrictions (to be provided in regulations) that would be disregarded in valuing transferred assets. The IRS has had a §2704 regulation project on its Priority Guidance Plan since 2003. Proposed regulations purportedly have been drafted, but apparently the IRS believes that they would not

be valid without legislative changes to §2704. (Estimated 10-year revenue: $18.079 billion in 2013 Fiscal Year plan. The Congressional Budget Office and Joint Committee on Taxation refuse to score this proposal because it depends entirely on positions taken in regulations, and the IRS cannot consult with them about its thinking on provisions that might be in proposed regulations. The fact that the Department of Treasury Office of Tax Policy scores this provision at such a low estimated amount suggests that the §2704 additional proposed regulations may not eliminate practically all marketability discounts or be as restrictive as some have feared.)

(3) *New GRAT Requirements*. The proposal imposes three additional requirements on GRATs: (a) a ten-year minimum term would be required for GRATs, (b) the remainder interest must have a value greater than zero, and (c) the annuity amount could not decrease in any year during the annuity term. (Estimated ten-year revenue: $3.334 billion in 2013 Fiscal Year plan.) (As discussed below, the 2013 Fiscal Year budget proposal adds that GRATs would be subject to a maximum term of the grantor's life expectancy plus 10 years.)

A stir was created by S. 1286, "Trade Adjustment Assistance Extension Act of 2011" filed on June 28, 2011. It included this minimum GRAT term provision, (which has been included in a number of other bills), but this bill was unique in making the entire bill-including this revenue raising provision-effective retroactive to January 1, 2011. Apparently, no thought had been given to the inherent unfairness of applying this minimum GRAT term provision retroactively and planners generally continued to form GRATs in the second half of 2011 without the minimum term provisions.

c. *New Items in 2012 Fiscal Year Budget Proposal.*

(1) *Make Portability Permanent*. This proposal would permanently extend the provisions in TRA 2010 regarding the portability of unused exemption between spouses. (Estimated 10-year cost: $3.681 billion in 2012 Fiscal Year plan.) This proposal was adopted in ATRA.

(2) *Limit Duration of GST Exemption*. The proposal would limit the GST exemption to 90 years after a trust is created. This would be accomplished by increasing the inclusion ratio of any trust to 1 on the 90^{th} anniversary of the creation of the trust. GST exemption would have to be reallocated after 90 years in order for the trust to remain GST exempt. The proposal would apply to trusts created after the date of enactment and to the portion of preexisting trusts attributable to additions after that date. (Estimated ten-year revenue impact: Negligible.)

That proposal was included in H.R. 3467, The Sensible Estate Tax Act of 2011, sponsored by Rep. Jim McDermott (D-WA). The general rule under that bill provides as follows:

> In the case of any generation-skipping transfer made from a trust after the date which is 90 years after the date on which such trust is created, the inclusion ratio with respect to any property transferred in such transfer shall be 1.

The bill provides special rules to deal with deemed separate trusts under the GST rules and the creation of pour-over trusts from another trust.

(3) *Reporting Requirements for Sales of Life Insurance Policies and Elimination of Transfer for Value Exceptions.* Sales of policies with a death benefit of $500,000 or more would have to be reported, and the exceptions to the transfer for value rules would be eliminated. The transfer for value exceptions provide extremely helpful flexibilities for planning with life insurance. Planners should review existing irrevocable life insurance trusts or life insurance-funded buy sell agreements to determine if adjustments should be made while we still have the flexibility of using the transfer for value exceptions for transfers of policies for valuable consideration.

(4) *Eliminate Minimum Distribution Rules for Small Qualified Plans or IRAs.* The 2012 Fiscal Year Plan proposes the elimination of required minimum distributions for an individual whose aggregate IRAs and qualified retirement plan amounts are $50,000 or less. (The 2013 Fiscal Year plan modifies that to apply to plans valued in the aggregate at $75,000 or less.)

d. *New Items in 2013 Fiscal Year Budget Proposal.*

(1) *Exemptions and Rates.* The proposal uses the 2012 system as the assumed "baseline," and proposes returning to a $3.5 million estate tax exemption and $1.0 million gift exemption, with a maximum 45% rate. ATRA adopted $5.0 million indexed estate, GST *and* gift exemptions and a 40% rate.

(2) *GRAT Maximum Term.* There would be a maximum term imposed on GRATs — the grantor's life expectancy plus 10 years. (This would remove the planning strategy suggested by some planners of using a very long term [say 100 years]. Under this strategy, at the grantor's death, the amount included in the estate would be based on the amount which if multiplied by the AFR *at the date of death* would equal the annual annuity amount. If AFRs increase significantly prior to the grantor's death, this could mean that a significant portion of the assets in the GRAT would not be included in the grantor's estate.)

(3) *The Bombshell: Grantor Trusts Would Be Included in Grantor's Gross Estate.* The 2013 Fiscal Year budget plan added that if a trust is a grantor trust, the trust assets would be included in the grantor's estate for estate tax purposes, any distribution from the trust would be treated as a gift, and conversion to non-grantor trust status would also be treated as a gift. The same rules would apply to section 678 trusts if the deemed owner sells assets to the trust (as to the sale transaction assets, income and appreciation from those purchased assets). The transfer taxes are payable out of the trust. The amount subject to the estate tax on death or the gift tax on a distribution or conversion to non-grantor trust status would be reduced by the value of any taxable gift made to the trust by the deemed owner. However, any trusts includable in the grantor's gross estate under existing law (e.g., GRITs, GRATs, QPRTs, etc.) would not be impacted. Regulatory authority would be granted to provide "transition relief for certain types of automatic, periodic contributions to existing grantor trusts." (Query, is this referring to continuing premium payments to irrevocable life insurance trusts, meaning that after the transition period the ILIT would be subject to estate inclusion? Apparently the intent is that this would just provide transitional relief and not have the effect of "grandfathering" trusts that have automatic periodic contributions.).

The proposal applies to trusts created on or after the date of enactment and the portion of pre-enactment trusts attributable to contributions made on or after the date of enactment (but not the portion attributable to sales made after the date of enactment, thus permitting sales to "grandfathered" grantor trusts as a planning strategy). This proposal is estimated to raise $910 million over 10 years (which is extremely small in relation to the wide use of grantor trusts; for example, the 10-year minimum GRAT term provision is expected to raise $3.3 billion over 10 years and the consistency of basis provision is expected to raise $2.0 billion over 10 years).

This proposal is a dramatic change and would have far-reaching effects. For example, many irrevocable life insurance trusts are grantor trusts under §677(a)(3). Irrevocable trusts that become foreign trusts by the appointment of a foreign person as trustee would be grantor trusts and therefore included in the gross estate. Irrevocable trusts that become grantor trusts by the appointment of successor trustees such that more than half of the trustees are related or subordinate parties would be included in the gross estate, and that could not be cured by the subsequent appointment of non-related persons as trustees because that would trigger a gift tax on the conversion to non-grantor trust status. Irrevocable trusts with the grantor's spouse as a potential beneficiary (which are grantor trusts under §677(a)(1)-(2)) would be included in the grantor's gross estate.

Because of the far-reaching potential impact and because of the complexity of working out the details of this provision, it is probably not "ripe enough" to be included in any reform package considered by Congress this spring. (The GRAT provision is more likely for inclusion in a tax reform package this year, since it has been included in various prior legislative bills and is not controversial.)

(4) *Section 6166 Estate Tax Lien.* The special estate tax lien under §6324(a)(1) would last for the full period that estate tax is deferred under §6166 rather than being limited to just 10 years after the date of death.

e. *2012 Transportation Bill.* A $9.8 billion financing proposal to be offered as an amendment to S. 1813 (the 2012 "transportation bill") was approved by the Senate Finance Committee on February 7, 2012, led by Chairman Baucus (D-Mont.). The largest funding provision (estimated to raise $4.68 billion) in that proposal provided that in most cases, distributions of inherited qualified retirement plans and individual retirement accounts would have to be distributed *within five years* of the death of the account holder. There were various exceptions, including situations in which the beneficiary of the IRA is the surviving spouse of the participant, is disabled, is chronically ill, is an individual who is not more than 10 years younger than the participant, or is a child who has not reached the age of majority. The provision is obviously a major change from prior law, which typically allows benefits to be paid out over the lifetime of the oldest beneficiary of the plan, and it would be a really rude surprise to persons who have converted the IRAs to Roth IRAs (paying substantial up-front income taxes) thinking that the long-term tax-free earnings within the Roth IRA could continue over the lives of the IRA beneficiaries.

This funding provision met immediate widespread opposition and the inherited retirement plan funding measure was dropped the same day to reach bipartisan approval in moving forward with the full Senate. However, comments from Senate leaders the following day suggests that this is an issue under consideration and that it *may be considered again at some point*. In a report from BNA Pension & Benefits Daily, Senator Kyl (R-Az.) said the IRA offset — not previously discussed for the transportation reauthorization—"*is an issue that both parties recognize*" but it is perceived as being related to estate taxes and might be better suited to a discussion later in the year about the estate tax. Senator Baucus seems to still be pushing this provision, reasoning that qualified retirement plans are not meant to be used as vehicles for transferring long-term wealth to beneficiaries.

f. *Likelihood of Passage in 2013*. Ron Aucutt observes that predicting future legislative actions at this point is very difficult:

> Prediction can take the form of applying known principles, policies and preferences to a known environment, and then predicting the outcome. When the only known principle, policy or preference is to annoy, impede, embarrass or blame the other folks--that looks not so much to the outcome as to the blame for the outcome--it is not easy at all to predict.

Senator Mitch McConnell and other Congressional leaders have said Congress will be dealing with "loophole closers," (despite earlier statements from Republican leaders that "we are done with raising revenue"). For example, it is not inconceivable that valuation discounts might be one of the "loophole closers" that would be included. However, most of the speakers at the Institute thought that the valuation discount provision and the grantor trust provision are both unlikely to pass this year. But prediction is hard in a climate when the typical rational calculus is set aside.

3. Treasury-IRS Priority Guidance Plan

a. *2012-2013 Guidance Plan*. The 2012-2013 Priority Guidance Plan (for the 12 months beginning July 1, 2012) was released on November 19, 2012. The plan includes additional guidance on supporting organizations, and a broad range of projects regarding implementation of the Foreign Account Tax Compliance Act (FATCA). Ten projects are listed under the heading of "Gifts and Estates and Trusts." The list includes a number of items that carried over from last year. There was one new item, dealing with the allocation of GST exemption at the end of an ETIP (such as at the termination of a GRAT).

b. *Completed Items*. Eight items that were on last year's list were dropped because the projects were completed including, among others, portability guidance, the effect of substitution powers under §2042 and guidance regarding protective claims for refund.

c. *New Project--GST Exemption Allocation At End of ETIP*. This new item derived from a request for guidance from the AICPA in comments to propose regulations submitted in 2004 and subsequently in a letter to the Internal Revenue Service in 2007. It raised issues regarding the allocation of GST exemption at the end of the initial term of a GRAT. For example, if the assets pass partly to a trust for children and partly to a trust for grandchildren, will GST exemption be automatically allocated to both trusts, and if so, what are the alternatives for opting out of such pro rata automatic allocation? Is it possible to opt out of automatic allocation for the trust designed just for the children?

d. *Decanting*. Notably, one of the items on last year's list that was dropped was "notice on decanting of trusts under §§2501 and 2601." Notice 2011-101 was issued (requesting comments on various tax issues regarding decanting). Apparently, the IRS view is that the issuance of any actual guidance regarding decanting will not be forthcoming for some extended time, and this year's list includes no projects regarding decanting. Interestingly, the preamble to the Priority Guidance Plan states that "[t]he plan represents projects we intend to work on actively during the plan year and does not place any deadline on completion of projects." Does this suggest that the IRS will not even be working on the decanting project this year?

e. *Carryover Items*. Carryover items from prior years include, among other things: (1) final regulations under §67(e); (2) adjustments to sample CRAT forms; (3) final regulations under §2032(a) (commonly referred to as the "anti-Kohler regulations"); (4) effect of guarantees and applying present value concepts under §2053 (which could impact the use of "Graegin loans"); (5) regulations under §2704 adding additional restrictions that should be disregarded in valuing the transfer of interests to family members in entities; (6) private trust companies guidance; and (7) guidance under §2801 regarding the tax imposed on U.S. citizens and residents who received gifts or bequests from certain expatriates.

f. *Highest Priority*. The highest priority is guidance under §2801 regarding gift or estate tax imposed on gifts or bequests to U.S. persons by certain expatriates.

4. Possible Tax Reform Legislative Developments

Lindy L. Paull gave the *Lloyd Leva Plaine Distinguished Lecture* — Federal Tax Policy: Will Tax Reform Be the Cure-All? She is a part of PwC's Legislative and Regulatory practice in Washington D.C. She served as Chief of Staff of the U.S. Congressional Joint Committee on Taxation for five years (1998-2003), was deeply involved in the structuring and drafting of the 1986 Tax Reform Act, and has had a long experience in her career with the development of legislation in Congress and tax reform.

a. *Congressional Committees Have Been Working on Tax Reform*. The Congressional tax-writing committees have spent a lot of time over the last year laying the groundwork for comprehensive tax reform.

b. *Tax Reform Drivers*. Drivers of tax reform include the following: (1) unpredictability (for example, there are 60 smaller provisions that are expiring at the end of 2013 unless extended); (2) complexity of the Code; (3) fairness (the relative portion of taxes paid by high income earners was a huge issue in the debate over the 2012 act, and that issue will continue); (4) business pressure (95% of consumers are outside the U.S., and this country has a difficult competitive issue because of the corporate tax rate and how we treat foreign earnings of U.S. based companies; the U.S. has the highest corporate tax rate in all of the OECD countries).

c. *Budget Deficit*. Projections are that the budget deficit will be about 6 to 7% of GDP. The federal debt has risen to 70% of GDP as a result of the financial crisis, and is expected to rise to 90% of GDP over the next 10 years. Will tax reform be a part of the budget deficit solution?

d. *Budget Proposal*. The administration historically releases a budget proposal about February 1, but this year it will be about March 1. The sequesters (automatic spending cuts) were extended until March 1.

e. *Expedited Legislative Process*. Between now and March 1 there will be much discussion about putting in place more processes to work on deficit reduction solutions. There has been discussion behind the scenes about adopting an expedited process for comprehensive tax reform. More details will be coming about what that means, but it is possible that something could happen in the near future.

f. *Progressivity*. Progressivity is a very important aspect of reform. The Code is more progressive this year than last year, and it will remain just as progressive following tax reform. The top 10% earn about 40% of the income and pay 50% of total taxes and 78% of income taxes. That group will continue to pay that portion after any tax reform.

g. *Individual Tax Reform*. The individual income tax is the largest component of tax revenues, representing $1 trillion out of $2.3 trillion of total revenues (2011 numbers). Ninety percent of the "tax expenditures" (special exclusions, deductions, credits, etc.) relate to the individual income tax. The large ones will be difficult if not impossible politically to repeal outright. The emphasis is on looking to other ways of limiting the "tax expenditures" other than outright repeal of the large ones.

There are various aspirational goals to reduce the top rate. The Bowles-Simpson Commission called for a 28% rate with the elimination of all tax expenditures. The House Republicans have a 25% goal (but with no details about setting limits on tax expenditures).

h. *Business Tax Reform*. The trend in the OECD is toward eliminating worldwide tax systems but adopting territorial tax systems. There were only six countries left (the U.S. is the largest) that use worldwide taxation. Other countries had an advantage when they reformed their business tax, because they had a broad-based consumption tax at the federal level. The U.S. relies on income tax for 45% of its revenues, but other countries rely on the income taxes for just 35% of revenues. That is a huge difference. At the federal level, the U.S. has very low excise taxes.

The President's framework for business tax reform – mostly corporate – would reduce the rate from 35% to 28%. The President is not in favor of a pure territorial system (no country has a pure territorial system, there is always a mechanism to adjust for transfer pricing issues or base erosion issues). The House Republicans have a goal of reducing the corporate tax rate to 25%; House Ways and Means Chairman Camp has proposed a bill with a detailed territorial tax regime to replace the current worldwide tax system.

i. *Key Steps*. Key steps in the upcoming tax reform discussions are as follows:

- President's budget submission, expected in early March;
- Congressional hearings on the budget;
- Committee decision on how to approach tax reform; and
- The normal process of hearings, committee markups, getting input from outsiders, etc; the process will start in the House and then move to the Senate.

5. Planning for Donors Who Made Large 2012 Gifts

a. *The Work Has Not Ended*. Many planners were extremely busy in late 2012 working with clients who wanted to make large gifts in case the estate and gift exemptions were reduced in 2013. The work is not over. Fortunately, one potential problem that has passed is that there is no "clawback" issue that would have existed if Congress had reduced the estate exemption below the amount of gift made using the $5 million indexed gift exemption.

b. *Review Transfer Mechanics*. Make sure that the appropriate transfer mechanics were carried out.

c. *Revise Estate Planning Documents*. Determine whether estate planning documents should be revised as a result of the large gift(s).

d. *Educate Client About Administering Trusts.* Planners must educate clients how to administer trusts. It is imperative that the grantor not use any of the trust assets without paying fair rental for the use. For example, if art is transferred to a trust, the art should not be left hanging on the grantor's wall, unless the grantor pays appropriate rent. Similarly, if a vacation home is transferred to a trust, the donor or should pay a fair rental for any use of the home.

e. *File Gift Tax Returns.* An unusually large number of gift tax returns may be filed for the 2012 gifts. In 2011, there were 220,000 gift tax returns filed. Predictions are that there will be over 500,000 returns filed for 2012 gifts. With about 350 estate tax examiners, we can see what will fill the audit pipeline through 2015. (The number of estate tax returns is expected to decline from about 170,000 in 2008 to about 9,000 [of which 3,600 will be for taxable estates] for 2011 decedents.)

- In light of the special planning for gifts in 2012 (e.g., SLATS, non-reciprocal gifts, etc), there will be many "interesting gift tax returns." Ron Aucutt observes, "I can't think of a worse gift tax return than an interesting one."
- Despite the fact that many more gift tax returns will be filed than in the past, do not assume that a less rigorous standard of completeness is justified. Planners should apply rigorous standard of care in preparing and reviewing the gift tax returns and associated appraisals.
- Gift tax returns look deceptively simple, being only five pages long. However, they are extraordinarily difficult. Furthermore, preparers often do not prepare many Form 709s. Planners who planned the large 2012 gifts should either prepare or carefully review the gift tax returns. (Be aware that a practitioner who gives advice to someone who signs a return is treated as a return preparer under Circular 230 and is subject to the preparer penalty provisions.)
- Do not underestimate the importance of having the preparer understand the underlying assignment and trust documents.
- Review past gift tax returns to make sure that the 2012 return accurately reflects prior gift information.
- Ask the donor if prior gifts have been made. If not, back gift tax returns should be filed for those prior years. A planner may not have a duty to correct prior returns that were inadvertently incorrect, but a preparer does have a duty not to report a wrong number in this year's return that the preparer knows is incorrect because it does not reflect prior gifts.
- Standard technical issues that arise include availability of the annual exclusion, gift splitting, and proper GST exemption allocation. See Item 6 for a detailed discussion of GST exemption allocation issues on gift tax returns.
- Create a separate file jacket for the gift tax return, separate from the file jacket for the planning transaction, to help in protecting the attorney-client or accountant-client privilege for planning transactions as opposed to return preparation.
- Do not rely on automatic allocations of GST exemption; affirmatively opt in or opt out of automatic allocation; opting into automatic allocation for all future transfers to the trust can be helpful (Carol Harrington points out that it is difficult to imagine a

situation where the decision would be to timely allocate GST exemption in one year and not in all later years);

- Carol Harrington gives sage advice regarding the preparation of any tax returns:

> When you are preparing a tax return, always remember that while you're representing a client, the first thing you have to worry about is yourself. We never do anything that might be considered fraud or misleading or anything that would put us in jail…We don't wish to be hit with any kind of fraud penalties and don't want to be disbarred from practice…You don't have a single client who is worth taking those risks.

f. *Consider Further Transactions With Gift Trust.* In light of the time crunch at the end of 2012, some clients made gifts of easy-to-value and easy-to-transfer cash or cash equivalents in 2012. Consider exercising substitution powers or sales to swap in assets with more appreciation potential and that may be able to take advantage of valuation discounts. Also consider additional sales to trusts to leverage the equity value in the trust from prior gifts.

Leave sufficient time between funding and transferring interests in entities to avoid step-transaction arguments under the *Holman/Gross/Linton/Heckerman* theories.

g. *Whether to Make QTIP Election for QTIPable Trust.* The donor may have made the gift to a "QTIPable" trust for the other spouse. This allows the donor to defer the decision of whether to treat the transfer as a taxable gift utilizing the grantor's lifetime gift exemption amount (or requiring the payment of current gift taxes) until the grantor's gift tax return is filed (possibly until October 15 of the following calendar year), based on whether or not the QTIP election is made for the trust. In addition, this approach may permit making a partial QTIP election like a defined value clause to make the election by formula over so much as is needed to avoid paying gift tax. Also, if the QTIP election is made, the donor's GST exemption could be allocated to the trust by making a reverse QTIP election.

If the donor made a gift to a QTIPable trust, and if the donor's assets are well under the $5 million estate exemption amount, in light of the adoption of a permanent indexed $5 million estate tax exemption, the donor may consider choosing to make the QTIP election so that there would be a step up in basis at the death of the donor's spouse, and to rely on portability to take advantage of the donor's estate tax exemption if the donor predeceases the spouse.

h. *Gift Splitting Election For 2012 Gifts.*

(1) *Gift Splitting for Gifts to SLATs.* If a donor makes a gift to a trust of which the donee-spouse is a beneficiary, the gift splitting election applies only as to the non-spousal portion of the gift, which must be both ascertainable and severable from the donee-spouse's interest. This may be difficult to establish. See Item 15.e.

(2) *Large Gift by One Spouse In Case Exemptions Had Decreased in 2013.* In some situations, couples did not make large enough gifts to fully utilize both of their $5.12 million exemptions, and the strategic plan was to have one spouse make a full $5.12 million gift with a lower gift by the other spouse. That way, if Congress had reduced the estate exemption below $5.12 million, at least one of the spouses would have taken advantage of the possibility of removing the additional amount over the reduced estate exemption from the estate tax base without any gift or estate cost. Now that we know Congress did not reduce the estate exemption,

making the split gift election may be preferable — for being able to utilize both spouses' gift exemptions in the future and if nothing else for the convenience of keeping track of the gift exemptions (and GST exemptions if appropriate) used by the spouses.

(3) *Agreement by Donee-Spouse To Consent to Gift Splitting.* If a donor made a $10 million gift in 2012 and was concerned that the donee-spouse might not agree to gift splitting, the donor or may have secured an agreement by the donee-spouse to consent to gift splitting. Is consideration required for such an agreement? Does the consenting spouse become a grantor of that trust because he or she received consideration? Another approach would be to provide that the gift is made as a net gift, so that any gift tax would be paid out of the trust and not by the donor.

(4) *Payment of Tax by Ill Spouse.* If gift tax is due even following the gift splitting election and if the donee-spouse is ill and likely to die within three years, the healthy spouse should pay all of the gift tax (assuming the healthy spouse has assets to pay the gift tax). (The gift tax is a joint and several liability of the spouses if gift splitting is elected, but the donor-spouse has primary liability for the tax.) If a spouse dies within three years, gift tax paid by the spouse will come back into the estate. §2035(b). But if the healthy spouse who lives at least three years pays the gift tax, none of that gift tax is brought back into the estate of the spouse who died within three years of making the gift — even if the ill spouse's property was used to make the gift.

i. *Statute of Limitations*; *Adequate Disclosure.* One reason to file the gift tax return is to commence running the statute of limitations (three years, or six years if omitted gift assets are worth 25% of the total gifts). However, adequate disclosure under §6501 (and the §6501 regulations) is required for the statute of limitations to run. Having a timely qualified appraisal is often the easiest way to satisfy the requirements. However, an appraisal is not required with respect to a transaction that is reported as a non-gift transaction.

j. *"Donor's Remorse" Over 2012 $5 Million Gifts*. For some clients, the decision in 2012 to make $5 million (really $5,120,000) gifts was very difficult. Some of those clients did so anyway, because of the possibility that the very large $5 million exemption was a mere window of opportunity that would close after 2012. Some individuals who made the large gifts in 2012 (and may have concerns about whether they may at some point need access to some of those funds) may now wish they had not "pulled the trigger" on the gifts in 2012.

(1) *Reminder of Gift Advantages.* Even though the $5 million gift and estate exemption did not disappear in 2013 as feared, remind the donor of the advantages as well as possible disadvantages of the gift. If the client's major concern is access to funds, the possibility of distributions to the spouse or loans to the donor may satisfy that concern. Clients may overreact immediately in light of the extension of the $5 million exemption, but Dennis Belcher warns that he would not want to see a donor hate having made the gift, undo the gift and later hate undoing it.

(2) *Disclaimer.* If all of the donees disclaim, gift assets presumably would return to the donor. However, if all of the donees do not disclaim, the assets would pass to the alternate takers rather than being returned to the donor. Gifts to trusts are

particularly suspect; the disclaimed assets may not return to the settlor but to other trust beneficiaries. *See generally* Handler & Chen, *Formula Disclaimers: Procter-Proofing Gifts Against Revaluations by Service*, 96 J. TAX'N 231 (April 2002).

Some instruments provide that the trustee is authorized to disclaim. What is the effect of such a provision? Carol Harrington says that there is nothing in modern law saying that a trustee can refuse to accept property and have it returned to the donor. (Bogert cites several cases, but those appear to involve trusts designed particularly for one specific trustee.) Perhaps the "revert to donor" result would occur only for an outright gift rather than a gift in trust that is disclaimed by a beneficiary.

A trust document could provide specifically that if a trustee disclaims, the disclaimed assets would return to the donor. A possible concern is whether acceptance or implied acceptance by the trustee has already occurred, which would make the disclaimer impossible. (However, the regulations state that "Merely taking delivery of an instrument of title, without more, does not constitute acceptance." Treas. Reg. §25.2518-2(d)(4).) If the "revert to settlor" trust language changes the result that would otherwise occur under state law, questions may conceivably arise as to the completeness of the gift. Also, questions could exist regarding the trustee's ability to exercise the disclaimer under the trustee's fiduciary duties to preserve the trust assets for the benefit of the trust beneficiaries. The IRS has expressed concern about recognizing for tax purposes the disclaimers of powers by trustees. For example, various divergent cases and rulings have addressed whether a trustee can disclaim a power to make a distribution to a non-spouse beneficiary, in order to qualify the trust for QTIP treatment. In *Cleveland v. United States*, 88-1 U.S.T.C. ¶13,766 (C.D. Ill. 1988), a marital deduction was allowed for a trust, for which a corporate trustee had disclaimed its power to utilize income or principal for the children's college education. However, while some IRS rulings have approved disclaimers of powers, most have refused to recognize a disclaimer of a "tainted" power in order to qualify a trust for QTIP treatment. *E.g.*, Tech. Adv. Memo. 8729002 (disclaimer by surviving spouse as trustee of power to invade corpus for children ineffective to qualify the trust for QTIP treatment).

A published revenue ruling makes reliance upon a disclaimer of a power particularly questionable. Rev. Rul. 90-110, 1990-2 C.B. 209; *see also* Tech. Adv. Memo. 9818005.

Some private letter rulings have recognized renouncement of powers by trustees. Letter Ruling 200401011 recognized the validity of a trustee's disclaimer of the power to make distributions to an unlimited number of charities for purposes of determining that the trust(which made the ESBT election) was a qualified shareholder of an S corporation. The ruling implicitly makes the determination that the disclaimer of the power to make distributions to an unlimited number of charities is valid under applicable local law. Letter Rul. 200401011.

Another ruling that recognized renouncing of powers by a trustee is Letter Ruling 200404013. In that ruling, an irrevocable trust named the grantor's wife and a bank as co-trustees. The trust acquired a joint and survivor life insurance policy on both spouses' lives. The wife executed an instrument renouncing her right as trustee to change the policy beneficiary, to revoke any change of beneficiary, to assign the policy, and to revoke an assignment of the policy. The ruling concluded that the wife, as trustee, would have no incidents of ownership in the policy held by the trust.

The Tax Court has refused to give effect to renunciation of powers by trustees for purposes of determining whether the trust qualifies for the estate tax marital deduction. *Estate of Charles Bennett v. Comm'r*, 100 T.C. 42 (1993). The court observed that there was no statement of intent regarding qualification for the marital deduction in the will or trust agreement, and no extrinsic evidence of the decedent's intent was presented. The Tax Court concluded that it would not permit the trustees "to disclaim powers, duties and discretions that would amount to a renunciation of their trusteeships." *See* Tech. Adv. Memo 9135003.

(3) *Rescission*. If a disclaimer will not work, could there be a rescission of the 2012 gift? If a gift is made under a mistake of a material fact, rescission may be possible under state law if the donees have not substantially changed their position in a way that would make the rescission unconscionable. The question is whether a business judgment of what legislation may or may not pass in the future is a mistake of fact or just an error of judgment. A recent rescission case, *Breakiron v. Guidonis*, 106 A.F.T.R.2d 2010-5999 (D. Mass. 2010), allowed rescission of a disclaimer from a QPRT on the basis of a mistake of law as to the effect of the untimely disclaimer. In *Stone v. Stone*, (a 1947 income tax case) a rescission was permitted of gifts to children that were made under the mistaken assumption that the income tax from the gift assets would be shifted to the donees. In *Neal v. United States*, 187 F.3d 626 (3rd Cir. 1999), the donor relinquished a retained power to avoid triggering the old §2036(c), which was later repealed retroactively. *See also Berger v. United States*, 487 F. Supp. 49 (Pa. 1980) (rescinded gift not taxed); *cf*. Rev. Rul. 80-58, 1980-1 C.B. 181; Ltr. Ruls. 200613027, 200701019, 200911004 (income rulings relying on rescissions to undo transactions).

Rescissions have generally relied on a retroactive change in law or bad advice; no case has been located based on a wrong guess of what the law would be in the following year. For example, the rescission was allowed in *Neal* because of not knowing that §2036(c) would be repealed retroactively.

The notion that rescissions are respected only if they occur in the same taxable year is an income tax concept. *See* Rev. Rul. 80-58, 1980-1 C.B. 181 (rescission occurring in same year as taxable event is respected if parties are returned to their original positions). Completing a rescission in 2013 of a 2012 transaction may still conceivably be recognized for transfer tax purposes even if that were not possible for income tax purposes.

The general consensus is that rescission of 2012 gifts based on the extension of the $5 million indexed estate and gift exemptions in ATRA is a significant extension of the general concept of rescission based on a mistake of law or fact, and that rescissions of 2012 gifts on that basis will be difficult. "Whether a gift should be made is not a mistake of law."

(4) *Exercise Swap Power or Repurchase Asset From Trust.* A donor may choose to exercise a substitution power or purchase assets from grantor trusts in return for long-term low-interest notes if the donor would like to re-acquire those assets (to

be able to enjoy the income produced by those assets or to be able to achieve a basis step up at the donor's subsequent death). That approach will not eliminate the gift but it might reduce the value remaining in the trust. *See generally Clay Stevens, The Reverse Defective Grantor Trust,* TR. & ESTS. 33 (Oct. 2012).

(5) *Borrow From Trust.* A very simple way that the donor may be able receive some cash flow assistance from the trust is to negotiate a loan from the trust. See Item 14 below.

(6) *Terminate Grantor Trust Status.* The donor may be able to take steps to terminate the grantor trust status of the trust so that it pays its own income tax going forward. However, that may reduce planning flexibilities in the future (i.e., swaps or sales would be taxable events) because the trust is no longer a grantor trust.

6. Generation Skipping Transfer Tax Reporting Issues

a. *Particular Significance for 2013*. Because of the large number of gifts made in 2012, there will be a very large number of gift tax returns filed in 2013. Most of the transfers in trust were probably meant to be GST exempt, thus requiring proper GST exemption allocations. The proper reporting of gifts, and the methods for making appropriate GST exemption allocations, and the methods to avoid or take advantage of automatic allocations is quite complicated. (Interestingly, the gift tax return instructions say that 1 hour, 53 minutes is required for "learning about the law or the form," that 1 hour, 58 minutes is required for "preparing the form," and that 1 hour 3 minutes is required for "copying, assembling, and sending the form to IRS." It is interesting that the IRS thinks it takes almost as much time to copy and mail the return as to learn all of the information in this Item as well as the other substantive law regarding gift taxation.)

b. *Methods of Allocating GST Exemption.* There are five ways of allocating GST exemption: (1) affirmative allocation; (2) deemed allocation to lifetime direct skips; (3) deemed allocation to lifetime transfers to GST trusts; (4) retroactive allocations; and (5) deemed allocation at death. The reporting issues for each are addressed separately.

c. *Affirmative Allocations.*

(1) *When Possible*. Affirmative allocations of GST exemption may be made at any time before the date prescribed for filing the estate tax return, including extensions. Observe: the taxpayer has until *after death* to allocate GST exemption.

(2) *Appropriate Valuation Date.* The valuation of property that is used for determining the inclusion ratio of the transfer depends upon whether the allocation is made on a timely filed gift tax return. For a timely filed return, the value on the date of the transfer is used; for a late return, the value on the date of the return is used, but there is a "first of the month" rule that permits using the value on the first day of the month in which the return is filed (other than for life insurance policies if the insured has died), because as a practical matter it is impossible to value an asset on the same day the return is filed making a late allocation. (The "first of the month" rule is only a valuation rule, and does not change the fact that the allocation does not actually take effect until the date on which the Form 709 is postmarked, as discussed below.)

(3) *Irrevocable*. An allocation of GST exemption becomes irrevocable after the due date of the return on which the allocation is made.

(4) *Coordination with Automatic Allocations*. Affirmative allocations may be very helpful in overriding automatic allocations that may inadvertently cause surprising (and bad) results. However, as discussed below, be aware that if there are any automatic allocations to lifetime direct skips, they take priority over affirmative allocations to other property in the same year (as well as to automatic allocations to indirect skip transfers).

(5) *Notice of Allocation.* The Notice of Allocation is now on Schedule D, rather than on Schedule C of the Form 709. The Return does not provide a form for notice of allocation, but Line 6 on Part 2 of Schedule D says "You must attach a Notice of Allocation." Regulations list requirements that must be included in a notice of allocation. Among other things, the value of trust assets at the effective date of allocation, the amount of GST exemption allocated, and the inclusion ratio of the trust must be specified. For these purposes, always use a formula to describe the amount of GST exemption allocated. (Diana Zeydel suggests using a formula even for cash transfers, in case there is an inadvertent mistake in the amount of the transfer.) Hundreds of requests for relief to make late but retroactive GST exemption allocations have been filed because taxpayers failed to file a Notice of Allocation.

(6) *Sample Notice of Allocation*. Materials by Diana Zeydel provide various forms for GST exemption allocations in various circumstances, including an affirmative allocation. A formula on the sample form for the amount of GST exemption being allocated states:

> The taxpayer hereby allocates to the assets transferred to The Doe Family 2012 Trust so much of the taxpayer's unused GST exemption as shall be necessary so that The Doe Family 2012 Trust shall have an inclusion ratio of zero for GST purposes or, if that is not possible, the taxpayer's entire unused GST exemption.

The Notice would state that the inclusion ratio is zero.

(7) *When Affirmative Allocation Takes Effect*. If the allocation is made on a timely filed return, the allocation is effective on and after the *date of the original transfer*. If the affirmative allocation is made on a late return, the allocation is effective on and after the *date of filing* (and as discussed above, the value on the date of the late allocation is used, taking due into account the "first day of the month" rule). If the exemption is made late, any allocation of GST exemption is deemed to precede in point of time any taxable event that occurs on that same date. Therefore, a Form 709 that is postmarked on a particular date making a late allocation could prevent the imposition of any GST tax with respect to a taxable distribution or taxable termination occurring on that same date.

d. *Deemed Allocations to Lifetime Direct Skips*. Unless the taxpayer opts out, GST exemption is automatically allocated to lifetime direct skip transfers (i.e., transfers directly to skip persons [generally, second-generation beneficiaries] or to trusts in which all interests belong to skip persons). That is generally good, because a direct skip would otherwise cause the imposition of a current GST tax.

(1) *Highest Priority Ordering*. A deemed allocation to a direct skip in a particular year precedes a deemed allocation to an indirect skip transfer in made in the same year,

and both will precede any affirmative allocation of GST exemption made to other transfers. To change the order or priority, effective elections out of the deemed allocation rules would be necessary.

(2) *Electing Out, Checking the Box*. Direct skips made during the calendar year are reported in Part 2 of Schedule A of Form 709. Column C contains a box to elect out of the allocation. However, the instructions state that checking the box is not sufficient to elect out of deemed allocation--a separate statement clearly describing the transaction and the extent to which automatic allocation does not apply must be attached.

One method of electing out of deemed allocation to a lifetime direct skip is to pay the GST tax. However that creates uncertainty, for example, if some portion of the direct skip transfer was not reported on the return. Does the election out of deemed allocation apply as to the extra amount also? Do not rely on merely paying GST tax to opt out of automatic allocation to lifetime direct skips.

(3) *No Deemed Allocation to Nontaxable Gifts*. Annual exclusion gifts directly to skip persons or to "vested single beneficiary" trusts for skip persons are nontaxable, and there is no deemed allocation to those gifts. However, if the "vested single beneficiary" trust exception does not apply, the nontaxable gift rule does not apply for transfers to trusts even if the entire gift is covered by a Crummey withdrawal power.

(4) *Sample Election Out.*

ELECTION OUT OF AUTOMATIC ALLOCATION OF GST EXEMPTION TO DIRECT SKIPS

The taxpayer transferred the sum of $500,000 in cash as a taxable gift not qualifying as a non-taxable gift to her grandchild, B, on October 1, 2012 as reported in Item 2, Part 2, SCHEDULE A. The taxpayer hereby elects that the automatic allocation rule applicable to direct skip transfers will not apply to the $500,000 transferred to B on October 1, 2012.

e. *Automatic Allocation for Lifetime Transfers to GST Trusts*.

(1) *Affirmatively Elect In or Out of Automatic Allocation*. There is automatic allocation of GST exemption for lifetime transfers to "GST trusts" which are defined in great detail in the statute as all trusts from which a GST transfer might later occur unless one of six detailed exceptions apply. It was impossible to draft the statute to describe precisely when parties would or would not want GST exemption to apply, so the statutory rules do not always achieve the appropriate allocation. Fortunately, the regulations provide that the taxpayer may elect into deemed allocation (in situations where the statute would not otherwise provide for automatic allocation) or may elect out of deemed allocation (in situations where automatic allocation would otherwise apply).

This provides a great deal of flexibility; the election out can be made, for example, as to the current transfer, all future transfers, transfers in several future years, etc. Alternatively, the taxpayer can elect in to automatic allocation, whether or not the trust technically qualifies as a GST trust, and Carol Harrington likes electing into automatic allocation for all future transfers to a trust if the settlor intends the trust to be GST exempt (even if the taxpayer actually reports and makes affirmative allocations of GST exemptions to later actual transfers to that trust).

(2) *Reporting Election In or Out on Form 709*. Column C on Part 3 of Schedule A of Form 709 provides a box to make all elections regarding automatic allocation of GST exemption to lifetime indirect skips (labeled "2632(c) election"). However, the return does not specify whether the election is an "election in" or an "election out" of automatic allocation. Therefore, it is critical to attach an election statement in order to make an effective election either in or out of deemed allocation.

Materials by Diana Zeydel include a sample "ELECTION OUT STATEMENT" for various types of situations listing all the information required in the regulations. The actual election portion of the Statement provides as follows:

> The taxpayer hereby elects that the automatic allocation rules will not apply to the transfer to The Doe Family 2012 Trust made by the taxpayer in 2012 or to any additional transfers taxpayer may make to The Doe Family 2012 Trust in subsequent years.

A sample "ELECTION IN STATEMENT" makes the following election:

> The taxpayer hereby elects that The Doe Family 2012 Trust be treated as a GST trust and that the automatic allocation rules will apply to any transfer to The Doe Family 2012 Trust in 2012 and to any and all future transfers the taxpayer may make to The Doe Family 2012 Trust.

The instructions state that if a prior election (in or out) has been made with respect to future transfers, the box in Column C should not be checked and no explanatory statement should be filed. However, that seems likely to create confusion, and Diana Zeydel recommends reminding the IRS that the taxpayer made an election in an earlier year, providing the following sample:

> NOTICE OF PRIOR ELECTION OUT OF AUTOMATIC ALLOCATION
>
> The taxpayer has previously elected that the automatic allocation rules will not apply to any and all transfers to the ____ Trust described in Item __. Part 3, SCHEDULE A; accordingly, no portion of the transferor's unused GST exemption shall be deemed allocated to the transfer described in Item __, Part 3 of SCHEDULE A.

(3) *ETIP*. GST exemption cannot be allocated during the "estate tax inclusion period," which is the period after a transfer during which the transferred property would be includable in the gross estate of the transferor or transferor's spouse (other than by reason of the three-year rule of §2035).

There are several exceptions to the ETIP rule. (1) The rule does not apply if there is a less than 5% actuarial probability that property will be included in the gross estate (which creates some uncertainty as to how the ETIP rule applies to GRATs). (2) The rule does not apply to a spouse who possesses a Crummey withdrawal power limited to a "five or five" power, if the withdrawal right terminates no later than 60 days after the transfer (so that GST exemption can be allocated to the trust from the date transfers were originally made). (3) The rule does not apply to an inter vivos QTIP trust for which the reverse QTIP election is made, allocating the transferor's GST exemption to the trust.

GST exemption can be allocated at the end of the ETIP term, and in fact automatic allocation applies if the assets at that time pass to a "GST trust." The final regulations confirm that an election out of deemed allocation to a transfer subject to an ETIP may be made on a Form 709 filed for any calendar year up to and including the calendar year in which the ETIP closes.

If an affirmative allocation of GST exemption is made to property subject to an ETIP, it is irrevocable after the due date of the timely gift tax return reporting the transfer. However, the allocation does not become effective until the close of the ETIP, and is therefore unlikely to cause the trust to be fully GST exempt.

(4) *Terminating Election Out on Deemed Allocation.* An election out of automatic allocation may be terminated on a subsequent Form 709 to the extent the election out applies to future transfers or to a transfer subject to an ETIP that has not yet occurred.

(5) *Gift Splitting Effect on Automatic Allocations.* A split gift election applies for GST as well as gift tax purposes. Therefore, if an automatic allocation applies, the exemption will be made one-half from each spouse. A split gift election may be filed on a late return, as long as it is the first gift tax return filed for that year. If a late return is filed to make the split gift election, there would be automatic allocation of one-half from each of the spouses.

If a split gift election is made and the spouses want to elect out of the deemed allocation rules, the election out must be made on both spouses' returns, not just the donor's return.

f. *Retroactive Allocation.* Retroactive allocation of GST exemption may be made if there is an unnatural sequence of deaths. For example, if a trust is created for a child and grandchildren, the transferor may not allocate GST exemption, thinking that the trust ultimately will probably pass entirely to the child. If the child predeceases the transferor, the transferor may make a retroactive allocation of any GST exemption available at that time, effective from when the original transfer was made to the trust. The retroactive allocation applies on a chronological basis, beginning with the first transfer to the trust (which prevents taxpayers from using hindsight to make more effective allocations of GST exemption just to transfers to the trust that had the most appreciation).

g. *Automatic Allocation at Death.* To the extent GST exemption is not affirmatively allocated during the transferor's lifetime and is not affirmatively allocated at death, a final set of deemed allocation rules allocates GST exemption, first, to direct skips occurring at death and, second, to trusts from which a GST transfer might occur. The exemption is allocated pro rata in step one and step two, respectively, if there is not enough exemption to cover all of the transfers. The deemed allocation at death rule applies even if the transferor had made an effective election out of the automatic allocation rules with respect to all transfers to the trust. To avoid pro rata allocations to testamentary trusts that may cause the trusts to be only partially GST exempt, affirmative allocations at death are preferable.

7. General Approaches to Estate Planning Following ATRA; The "New Normal"

a. *The "New Normal."* There is a "new normal" of estate planning in light of the (i) transfer tax certainty, (ii) large indexed transfer tax exemptions, and (iii) portability provided by ATRA. (In 2001, 120,000 estate tax returns were filed, of which 60,000 were for taxable estates. In 2012, less than 4,000 taxable estate tax returns were filed. Estimates are that less than 0.2% of Americans will be subject to the federal estate tax.) Income tax changes may significantly impact trusts.

b. *Planning For Married Couples Under $5.25 Million.* The major focus for estate planning for couples having assets under $5.25 million will be (i) core dispositive planning, (ii) income tax planning (for example, achieving basis step up at death), and (iii) preservation and management of assets.

(1) *Transfer Taxes Generally Irrelevant.* Transfer taxes will generally be irrelevant for clients in this range. One issue the clients will face is whether to make the portability election at the death of the first spouse. Filing an estate tax return and making the election will be preferable in most cases. The assets must be valued in any event for basis purposes, and the portability regulations allow a relaxed reporting procedure to merely list assets qualifying for the marital deduction rather than listing values of each of the assets. Filling out the estate tax return will not be overly onerous. If an estate tax return is not filed to make the portability election, the planner will want a clear waiver letter signed by the executor (and perhaps the beneficiaries).

(2) *Core Dispositive Planning.* Clients will continue to need estate planning documents disposing of their assets among their desired beneficiaries and coordinating beneficiary designations to achieve the desired result.

(3) *Income Tax Planning.* While transfer taxes may be irrelevant, income tax issues will remain. A key issue for clients in this range will be preserving a step up in basis at the death of each spouse. A simple will or revocable trust leaving all of the assets outright to the surviving spouse will achieve a basis adjustment at the deaths of both spouses. Alternatively, if a trust is desired for preservation, management or asset protection purposes, giving the surviving spouse a testamentary general power of appointment may be helpful to allow a basis adjustment at the surviving spouse's death.

Clients that have previously entered into estate planning transactions, such as creating entities, making gifts to trusts, etc., may want to reverse the effects of some of those transactions. For example, dissolving the entity may avoid valuation discounts that would otherwise limit basis adjustments at the owner's death. A settlor may want to take steps to attempt to cause trust assets to be included in the settlor's gross estate for estate tax purposes so that a basis adjustment would apply at the settlor's death.

Items 10-11 below address strategies to preserve basis step up in various situations.

(4) *Preservation and Management of Assets; Trust Planning.* A key decision will be whether to use trusts as part of the estate plan for non-tax reasons. (Indeed, using a trust could have tax *disadvantages* because the highest income tax rates and the

3.8% Medicare tax on net investment income apply to trusts with undistributed income of only $11,950 in 2013.) Reasons that a trust may be appropriate include:

- the surviving spouse is not capable of managing assets;
- there is a second marriage blended family and each spouse wants to control where his or her assets will pass;
- the parties have a fear of the spouse's remarriage or a concern of undue influence; or
- there is a need for asset protection or divorce protection.

As part of the decision process of whether to use trusts, keep in mind that there may be additional administrative costs for trusts (filing trust income tax returns, additional income taxes, etc.).

If a trust is used, consider allowing discretionary income and principal distributions for health, education, support and maintenance – not for tax reasons but to ensure that distributions are made when really needed. Consider giving the discretion to make distributions to children or to others with the consent of the spouse. Give the spouse a lifetime or testamentary general power of appointment in order to achieve a step up in basis at the surviving spouse's death. Be aware, however, that if asset protection is a concern, using a "HEMS" distribution standard or a general power of appointment may not be ideal.

(5) *Rethinking Traditional Planning Concepts*. In light of the fact the transfer taxes are irrelevant (absent "winning the lottery" or a change in future transfer tax laws), planners will need to rethink traditional planning concepts. For example, steps that are taken to assure qualification for the annual exclusion, to avoid retained interests in trusts, etc. may no longer be necessary. Putting up with owning life insurance in an irrevocable life insurance trust and the complexity of funding the trust to pay premiums would seem irrelevant for most of these clients.

(6) *Focus on Maintaining Standard of Living*. Rather than focusing on strategies for wealth transfer, these clients may focus much more on having sufficient assets to maintain the spouses during their retirement years.

(7) *Qualified Retirement Plans*. A large part of planning for retirement will be to structure withdrawals from qualified retirement plans so that they can last for the lifetimes of the spouses.

(8) *Elder Law/Medicaid Planning*. For clients with well under $1 million, planning for long-term and nursing home care is important. Endeavor to have an infirm person stay in the residence as long as possible since that is much less inexpensive than nursing home costs. See Item 38 below regarding elder law planning issues.

(9) *Low Interest Loans*. A common way of assisting relatives financially is to use loans at the AFR. However, bear in mind, that the interest payments will be taxable income to the client, and may or may not be deductible to the borrower, depending upon his or her use of the loan proceeds. If interest payments accrue, each year the client will still probably have to recognize the accrued income (i.e., a pro rata part of the original issue discount over the life of the loan).

(10) *Asset Protection Planning*.

- *Inter Vivos QTIP Trusts.* The clients may want to consider having one spouse create an inter vivos QTIP trust for the other spouse with spendthrift provisions. After the trust has been created, the assets should not be reachable by the creditors of either spouse. If the donee-spouse predeceases and the assets pass back into a trust for the original donor-spouse (either directly or by the exercise of a power of appointment by the donee-spouse, the assets may still be protected from the original donor-spouse's creditors. (Statutes in Arizona, Delaware, Florida, Michigan and Wyoming — and perhaps other states — make that clear.)
- *Lifetime Credit Shelter Trusts.* If one spouse creates a lifetime credit shelter trust for the other spouse, neither spouses' creditors should be able to reach the assets in the trust. If both spouses create trusts that are not reciprocal of each other (different time, different amounts, different trustees, different beneficiaries, different powers of appointment, etc.) both trusts may be protected from claims of the spouses' creditors (but that is a state law issue, not necessarily governed by the *Grace* reciprocal trust federal tax doctrine). If a spouse dies and exercises a power of appointment to appoint the assets in the credit shelter trust back into a trust for the original donor-spouse, those assets may still be protected from creditors of the donor spouse (depending on application of the "relation back" doctrine.) See Item 15.d below for a detailed discussion of this issue. Making transfers to a lifetime credit shelter trust also removes the assets from the gross estates of the individuals for estate tax purposes in case the exemption should later be reduced.
- *Tenancy by the Entireties.* Almost half of the states provide asset protection for assets held by the spouses in a tenancy by the entireties.
- *Homestead.* A number of states provide creditor protection for the personal residence claimed as a homestead.
- *Qualified Retirement Plans.* Assets in qualified retirement plans are generally exempt from creditors' claims.

(11) *State Transfer Taxes.* About half of the states have state estate taxes with exemptions considerably lower than the $5 million indexed federal exemption. For example, New York has a $1 million exemption. Planning to avoid state transfer taxes is important in those states.

One looming loophole strategy for saving state estate taxes is for the client to make gifts (even deathbed gifts) rather than owning the assets at death. Only one state (Connecticut) has a gift tax, and a few more have "contemplation of death" provisions for transfers within a certain period of time prior to death. If there is no state gift tax, lifetime gifts covered by the $5 million indexed federal gift exemption could be made totally free of federal or state gift or estate taxes.

(12) *Special Needs Trust Planning for Beneficiaries with Disabilities.* Third party special needs trusts that would take effect upon the deaths of parents of a disabled beneficiary may be able to provide "extras" for the beneficiary without disqualifying the person from qualifying for Medicaid assistance.

c. *Planning For Couples in $5-10 Million Range.* In addition to the planning issues discussed above, a primary estate planning decision for clients in this range will be whether to use a credit shelter trust or rely on portability at the first spouse's death. This is not an easy analysis for the planner (and is discussed in greater detail in Item 8 below).

(1) *Portability Decision — Overview*. Because the portability provisions have now been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. Planners know that there are a variety of advantages of employing trusts at the first spouse's death, but many clients may opt for the "cheapest" (and perhaps more important, the *simplest*) alternative.

An *optimal approach* may be to utilize planning that leaves the surviving spouse with the decision of whether or not to utilize portability. Alternatives are (1) to rely on a disclaimer provision (allowing a surviving spouse to disclaim an outright bequest with a provision that the disclaimed assets pass to a bypass trust) or (2) to leave assets to a QTIPable trust and either make a full QTIP election (and rely on portability) or make a partial QTIP election with a "Clayton" provision (so that the unelected portion would have more flexible distribution provisions than a single–beneficiary mandatory income interest trust for the surviving spouse; thus the unelected portion could look like a standard bypass trust).

Situations favoring an approach leaving all of the assets outright to the surviving spouse and relying on portability include:

- a competent spouse who can manage assets;
- a desire by the clients to avoid using trusts (taking into consideration the possible increased income tax and costs for administering trusts as well as the general fact that many clients are unfamiliar and uncomfortable with trusts);
- a first marriage or no children existing by prior marriage of either spouse;
- clients who are more interested in basis step up than getting future appreciation out of their estate;
- situations in which it is undesirable to retitle assets (for example to be able to utilize each spouse's exemption amount);
- the desirability of the surviving spouse being able to create a trust following the first spouse's death that would be a grantor trust as to the surviving spouse;
- there is a residence or other assets that would be difficult to administer in a trust; or
- qualified retirement plan assets are the predominant assets in the estate.

If a trust arrangement is desirable in any event (see Item 8.d below for a discussion of the advantages of using trusts in this context), QTIPable or credit shelter trusts can both be structured to leave flexibility to the surviving spouse regarding the portability decision. Also, in a blended family situation, substantial inequities may result if the credit shelter approach is not used.

Major Factors. In many cases the credit shelter trust vs. portability decision will come down to the following major factors:

Credit Shelter trust — (i) desirability of omitting future appreciation from the estate, (ii) being able to include the spouse and other persons as trust beneficiaries, and (iii) avoiding (or minimizing) inequities in a blended family situation; vs.

Portability — (i) administrative simplicity factors of outright ownership if a trust will not be used at all (forgoing asset management/preservation, the ability of the first spouse to control the ultimate disposition of the assets, and creditor protection advantages), (ii) desirability of a second basis step up at the second spouse's death, and (iii) ability to leave the assets in a trust for descendants of which the surviving spouse is treated as the owner under the grantor trust rules.

See Item 8 below for a more detailed discussion of portability planning issues.

(2) *State Exemption Planning*. For state estate tax planning purposes, creating a credit shelter trust to hold the state exemption amount will likely be desirable. As to the excess of the estate over the state exemption amount, some states allow a state-only QTIP election; however, using portability for the excess assets is probably simpler than using a state-only QTIP trust to hold the excess assets over the state exemption amount.

(3) *Income Tax Planning*. Income tax planning will become more important. The increased rates on high income taxpayers and the 3.8% Medicare tax will present planning opportunities. The 3.8% Medicare tax on net investment income is an additional factor that trustees will need to consider in determining the appropriateness of trust distributions. Trust distribution planning affords income shifting opportunities (and the 65 day rule allows making the distribution decisions after the end of the taxable year when the parties have the financial records.) Trust documents should give the trustee the authority to deem that distributions include capital gains. *See* Blattmachr & Gans, TAX NOTES at 901 (May 17, 2004). See Item 9 below for a more detailed discussion of trust planning considerations of the 3.8% Medicare tax. Basis planning may predominate transfer tax planning (other than the portability decision) in many situations.

d. *Planning for Couples Above $10 Million*. Traditional planning strategies for large estates will continue to apply.

(1) *Transfer Planning General Issues*. Planning issues include:

- Large gifts combined with sales or other leveraged transactions afford the opportunity of removing huge amounts from the transfer tax base for estate and GST purposes;
- Dealing with the complexities of gift splitting in order to take advantage of both spouses' large gift exemption amounts if the marital assets are owned predominantly by one spouse;
- Concerns over losing a stepped-up basis for gifted assets that are no longer owned by the individual at death;
- There will continue to be an urgency in creating and funding grantor trusts sooner rather than later in light of the Administration's proposal to restrict the advantages of using grantor trusts that are created and funded in the future and to restrict entity-based valuation discounts;
- Whether gifts should be made in trust—reasons include GST planning (if there is remaining exemption to allocate), asset protection, divorce protection, and management protection;
- What assets should be transferred--for valuation discounting and leverage reasons, entities will often be used; allow time between the funding of the entity

and any transfers; retain sufficient assets to provide living expenses; do not transfer personal use assets to entities; follow formalities for the entity;

- Defined value formula clauses may be appropriate for gifts or sales if the transfer utilizes most of the remaining available gift exemption amount;
- Sales can leverage transfers to increase significantly the transfer of future appreciation; if $5.12 million gifts have already been made to the trust in 2012, consider sales of appreciating assets to the trust in return for AFR-interest rate long term notes; the rule of thumb is that the sale amount can be 9 times the equity value of the trust from the prior gifts;
- Grantor trusts can dramatically increase the amount transferred over time by permitting tax-free compounding for the trust; if a grantor is reluctant to utilize a grantor trust because of the ongoing income tax liability, consider reducing the amount being transferred to the trust but still leaving it as a grantor trust (with someone having the flexibility to cause the trust to lose its status as a grantor trust as some point in the future);
- The gift exemption amount will increase each year with indexing (it increases by $130,000 in 2013 from $5,120,000 to $5,250,000) and the decision will have to be made how to best use the increased gift exemption amount each year; and
- Making gifts requiring the payment of gift tax to take advantage of the tax exclusive nature of the gift tax (assuming the donor lives at least three years after the gift), discussed further in Item 11.e.

Items 12-34 below address various transfer planning strategies.

(2) *Overview of Planning Considerations For Indirect Access*. Now that we know the gift exemption will continue at the high $5 million indexed level, some of the concerns that clients struggled with in 2012 about whether they might need access to any of the gift funds and planning alternatives to address those concerns will be ongoing. These include:

- The use of "spousal lifetime access trusts" (sometimes referred to as "SLATs"), including concerns over whether the donee-spouse can be given a testamentary limited power of appointment broad enough to appoint the assets back into a trust for the original donor-spouse if the donee predeceases, and including potential effects of creditors rights with respect to those trusts;
- The use of "non-reciprocal" trusts if married individuals want to include each other as potential beneficiaries of SLATs;
- A donor may choose to purchase assets from grantor trusts in return for long-term notes if the donor would like to re-acquire those assets (to be able to enjoy the income produced by those assets or to be able to achieve a basis step up at the donor's subsequent death); and
- If the donor is unwilling to make further gifts, the donor may be willing to make a late allocation of GST exemption to a prior trust (and if appropriate, later do a qualified severance to have a fully exempt and non-exempt GST trust).

See Items 14-25 below regarding planning strategies about possible "rainy day" concerns.

(3) *Example Large Estate Case Studies*. For a link to detailed large estate case studies with a checklist approach to the planning analysis see Item 34 below.

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

1. Planning for the disposition of the client's assets at his or her death.
2. Asset protection planning.
3. Planning for disability and incompetency.
4. Business succession planning (without the estate tax to blame for failure of a business).
5. Planning for marital and other dissolutions.
6. Charitable giving (for its own sake, and because income tax considerations will still be relevant and techniques, such as lifetime charitable remainder trusts to facilitate diversification, would not be affected at all).
7. Life insurance planning (other than to provide funds to pay taxes).
8. Fiduciary litigation (enhanced because more to fight over).
9. Retirement planning.
10. Planning to pay state death taxes (in many states).
11. Planning to avoid or minimize gift taxes (and client desires to gift more than the $5 million indexed applicable exclusion amount for gift tax purposes).
12. Using business entities to accomplish nontax objectives.
13. Planning for children with disabilities.
14. Planning for spendthrift children.
15. Planning for clients with real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to state estate tax).
16. Planning for clients who are U.S. citizens or resident aliens who own property in other countries.
17. Planning for nonresident aliens with assets in the U.S. or who plan to move to the U.S.
18. Planning for citizens who intend to change their citizenship.
19. Planning for possible decrease in the estate, gift, and GST tax exemptions and/or increase in the transfer tax rates.
20. Planning to pay education expenses, including contributing to I.R.C. §529 plans.
21. Planning to deal with non-tax regulatory issues, such as the Patriot Act, HIPPA, and charitable governance reform.
22. Identifying guardians for minor children, if and when needed.

8. Portability

a. *Permanent*. ATRA's making portability permanent is a major development that will arise as an issue for consideration in planning the estates of every married couple.

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

c. *Portability Decision Is Complex*. Because the portability provisions have now been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. From the planner's perspective, this is a more complex decision involving a variety of factors. Although the purpose of portability is to facilitate simplicity for clients, the possibility of relying on portability may in some cases make the planning process more complicated to communicate fully to clients the advantages and disadvantages of planning alternatives.

d. *Reasons for Using Trusts Even With Portability*. There are various reasons for continuing to use bypass trusts at the first spouse's death and not rely on the portability provision including, (a) the deceased spousal unused exclusion amount is not indexed, (b) the unused exclusion from a particular predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse, (c) growth in the assets are not excluded from the gross estate of the surviving spouse unlike the growth in a bypass trust which is excluded, (d) there is no portability of the GST exemption, (e) there is no statute of limitations on values for purposes of determining the unused exclusion amount that begins to run from the time the first deceased spouse's estate tax return is filed whereas the statute of limitations does run on values if a bypass trust is funded at the first spouse's death, (f) closely related is that the bypass could be funded with discounted hard to value assets when there may be a low audit risk at the first spouse's death, and (g) there are other standard benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse.

On the other hand, leaving everything to the surviving spouse and relying on portability offers the advantages of simplicity and a stepped-up basis at the surviving spouse's death. One possible method of dealing with the double basis step up issue is to use a credit shelter trust and plan it so that the "Delaware tax trap" can be triggered by the surviving spouse to cause the trust assets to be includable in the spouse's gross estate. (The credit shelter trust would give the spouse a limited power of appointment that includes the power to grant new presently exercisable powers of appointment. [The power to appointment in further trust would generally include this authority.] The decision of whether to trigger estate inclusion in the beneficiary's gross estate is then totally up to the spouse. If the surviving spouse wants to trigger estate inclusion, the spouse would exercise the original power to create a presently exercisable general power of appointment in someone else. That would cause estate inclusion in the surviving spouse's gross estate under § 2041(a)(3). Thus, the assets would receive a step up in basis, and the first deceased spouse's estate would make the portability election. See Item 11.d for a more detailed discussion of planning opportunities with the Delaware tax trap.

In a blended family situation, substantial inequities may result if the credit shelter approach is not used. If the assets are left outright to the surviving spouse, the spouse may give or bequeath the assets to persons other than the first decedent-spouse's descendants (or may favor some over others of those descendants in ways that the decedent-spouse would not have wanted). If even a QTIP trust is used, the surviving spouse may be able to take steps that would significantly disadvantage the decedent-spouse's descendants even though the assets are "protected" in a QTIP trust. For example, if the executor makes a QTIP election and elects portability, the surviving spouse will have the DSUE amount from the decedent-spouse and could make gifts of the surviving spouse's assets to his or her own descendants utilizing all of the DSUE amount and his or her gift exemption amount. (Alternatively, the surviving spouse could make a gift using just the DSUE amount, and at death might leave all assets owned by the surviving spouse to his or her descendants.) At the surviving spouse's death, the QTIP trust is required to reimburse the surviving spouse's estate for taxes attributable to the QTIP trust assets. In effect, the first decedent-spouse's descendants would not have benefitted at all from the first decedent-spouse's exemption amount. That could be addressed in a prenuptial agreement or other marital agreement, to agree that the portability election would be made if the surviving spouse agreed to waive reimbursement rights from the QTIP trust. For example, the decedent's will could direct the executor not to make the portability election unless the surviving spouse agrees to waive the right to be reimbursed for estate taxes from the QTIP trust at the surviving spouse's subsequent death. Having the assets pass to a credit shelter trust to assure that the first decedent-spouse's descendants are treated fairly avoids those complexities.

e. *Situations Favoring Portability.* There are some situations where planners may strategically decide that relying on portability is better than creating credit shelter trusts in the first decedent-spouse's will. Situations favoring an approach leaving all of the assets outright to the surviving spouse and relying on portability include (a) a competent spouse who can manage assets, (b) a first marriage or no children existing by prior marriage of either spouse, (c) clients who are more interested in basis step up than getting future appreciation out of their estates, and (f) there is a residence or other assets that would be difficult to administer in a trust. There are other special situations in which portability may offer distinct advantages, summarized below.

Qualified Retirement Plans. For the classic situation of a client whose major assets are a residence and retirement or IRA benefits, there is often no way to fully fund a bypass trust without using the retirement or IRA benefits. However, optimal income tax deferral typically results from naming the surviving spouse as the beneficiary. A possible planning strategy is to leave the retirement and IRA benefits directly to the surviving spouse and rely on portability to be able to utilize the deceased spouse's unused estate tax exclusion amount at the surviving spouse's subsequent death.

Retitling Assets. Traditionally, if one spouse owned most of the marital assets, in order to utilize the estate exemption amount of the less-propertied spouse if he or she died first, the wealthier spouse would have to retitle assets into the name of the less wealthy spouse or fund a QTIP trust for that spouse, often unpopular with the moneyed spouse. The reluctance will be even bigger with a $5 million exemption — a very large amount might need to be transferred to the poorer spouse. That can be avoided if the spouses are willing to rely on portability to take advantage of the less wealthy spouse's exclusion amount if he or she should die first. Many clients will find portability very attractive.

Saving State Estate Taxes. Using a credit shelter trust at the first spouse's death might generate significant state estate taxes, which could be avoided by using portability.

Creating Grantor Trust as to Surviving Spouse. Leaving assets to the surviving spouse or QTIP and using portability allows the surviving spouse to makes gifts using both spouses' exemption amounts and that full amount can pass to a trust that is a grantor trust as to the surviving spouse. For this purpose, portability may be desirable even for very large estates. A further advantage of this approach, as compared to funding a bypass trust at the first spouse's death, is that minority discounts may be larger if the gift is made to multiple trusts for multiple beneficiaries. If this advantage may apply in a particular case, and if the QTIP approach is used to leave the surviving spouse the flexibility of making the portability decision, the QTIP trust should give some third party wide discretion in making principal distributions to the surviving spouse (which the spouse could then use to make the gifts. (An obvious disadvantage of this strategy is that the spouse would not be able to be a discretionary beneficiary of the gifted assets.)

Consumption Exceeding Growth, Administrative Costs. Portability may be preferable if the spouse's consumption rate is expected to exceed the assets' growth rate or if administrative costs of maintaining the credit shelter trust are not justified.

Utilizing Deceased Spouse's GST Exemption and Getting Double Basis Step Up With Portability. If the QTIPable trust approach is used as a way of leaving the post-mortem flexibility of deciding how to use portability, the first spouse's GST exemption can be used even if the decision is made to make a QTIP election for the entire trust. A double benefit results: (1) the first deceased spouse's estate would make the reverse a QTIP election under §2652(a)(3) to utilize the first spouse's GST exemption; and (2) the assets would get a basis adjustment (hopefully a step up) at the deaths of both spouses. Some have questioned whether Rev. Proc. 2001-38, 2001-1 CB 1335 precludes the use of this strategy. It provides that the IRS will ignore a QTIP election "where the election was not necessary to reduce the estate tax liability to zero." If portability applies, the election is not required to reduce the estate tax liability to zero, so literally, the Rev. Proc. might apply. However, most commentators believe that Rev. Proc. 2001-38 does not preclude making a QTIP election even though the estate is relying on portability. The purpose of Rev. Proc. 2001-38 was to facilitate making use of the first decedent's estate tax exemption amount with proper trust planning and to keep an inadvertent QTIP election from achieving that result. Since the first spouse's exemption can be utilized by portability in any event, the Rev. Proc is no longer relevant (though the IRS has not revoked it). *See* Franklin, Law & Karibjanian, *Portability — The Game Changer* (January 2013), available at http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/heckerling/2013/portability_the_game_changer_2013_01_15_paper_2.authcheckdam.pdf.

f. *Major Factors*. In many cases the credit shelter trust vs. portability decision will include the following major factors: control by spouse, administrative simplicity, basis step up at both deaths, creditor protection, sheltering appreciation between the two deaths, and who pays income tax.

Credit Shelter trust — (i) desirability of omitting future appreciation from the estate, (ii) being able to include the spouse and other persons as trust beneficiaries (if a QTIP trust is used only the spouse is a beneficiary; if the spouse receives assets outright and makes a gift to a trust for descendants — which could be a grantor trust as to the surviving spouse, the spouse would not be a beneficiary), and (iii) avoiding (or minimizing) inequities in a blended family situation.

Portability — (i) administrative simplicity factors of outright ownership if a trust will not be used at all (forgoing asset management/preservation, the ability of the first spouse to control the ultimate disposition of the assets, and creditor protection advantages), (ii) desirability of a second basis step up at the second spouse's death, and (iii) ability to leave the assets in a trust for descendants of which the surviving spouse is treated as the owner under the grantor trust rules.

g. *Optimal Approach — Leaving Surviving Spouse Flexibility*. An optimal approach may be to utilize planning that leaves the surviving spouse with the decision of whether or not to rely on portability. Alternatives are (1) to rely on a disclaimer provision (allowing a surviving spouse to disclaim an outright bequest with a provision that the disclaimed assets pass to a bypass trust), or (2) to leave assets to a QTIPable trust; portability would be used if a full QTIP election is made (and the first deceased spouse's GST exemption could be used by making a reverse QTIP election under §2653(a)(3)), and a bypass trust approach would be used if a partial QTIP election is made with a "Clayton" provision (so that the unelected portion would have more flexible distribution provisions than a single–beneficiary mandatory income interest trust for the surviving spouse).

h. *Portability Election; Administrative Expenses.* The will could designate whether the executor would be required or have the discretion to make or not make the portability election. An alternative is to require the executor to make the election if the spouse so requests, or perhaps to require that the executor make the election unless the spouse agrees directs that the election not be made.

The expense of preparing an estate tax return to make the portability election will be borne by someone. Even with the simplifications allowed by the temporary and proposed regulations of not having to list the values of each asset passing to the surviving spouse or charity, there could still be a not insignificant expense in preparing the estate tax return to make the election. The will can address whether the estate or surviving spouse would pay the expenses of making the election. If the spouse is required to pay the preparation expense, that will likely reduce the marital deduction for assets passing to the spouse, which would reduce the DSUE amount. (However, the spouse's estate would be reduced by a like amount, so that should not increase the aggregate estate tax payable at the surviving spouse's subsequent death.) If the estate pays the preparation expense, it would be a estate transmission expense, and if the expenses are claimed for income tax purposes, the marital deduction would be reduced (Reg. §20.2056(b)-4(d)(1)(iii)(2)), which means the DSUE amount would be reduced by the amount of the expense.

i. *Temporary and Proposed Regulations — Overview*. Temporary and proposed regulations were issued on June 15, 2012. There are a few new general regulations for §§2010 and 2505 (interestingly, regulations were never previously issued for those statutes), but the newly issued regulations primarily provide guidance regarding the portability provisions included the 2010 Tax Act). The portability provisions generally allow a surviving spouse to use any unused exclusion from his or her deceased spouse. The regulations provide guidance on a variety of issues including election requirements, details regarding computing the unused exclusion amount, and the surviving spouse's use of the unused exclusion amount (either by gifts or for estate tax purposes following the surviving spouse's death).

The regulations generally provide very taxpayer-friendly positions (surprisingly friendly as to several issues) regarding a variety of issues. The regulations adopt reasonable positions, avoiding what would seem to be nonsensical results that might occur with respect to various issues under a literal reading of the statutory provisions of §2010(c)(4) and §2505 (the sections describing the unified credit against estate tax and gift tax, respectively). Perhaps the specific authorization in §2010(c)(6) for the Secretary of the Treasury to prescribe regulations necessary or appropriate to carry out that subsection afforded comfort in interpreting the statutory language very broadly in order to reach reasonable results.

The regulations apply to estates of decedents who died on or after January 1, 2011. However, the regulations expire in three years (if the proposed regulations are not finalized before that date).

Highlights of some of the more important provisions of the regulations include:

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

For a detailed discussion of the temporary and proposed regulations see Item 6(h-q) of the summary at

http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/12_2012_Estate%2520Planning%2520Current%2520Developments.html

9. Trust and Estate Planning Considerations for 3.8% Medicare Tax

a. *Basic Statutory Structure.* The tax on "net investment income" was technically part of the Health Care and Education Reconciliation Act of 2010, which was passed one week after the Patient Protection and Affordable Care Act, but the two statutes are collectively called the Affordable Care Act.

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

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

(ii) the individual's net investment income for the year.

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

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

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

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

b. *AGI of Estate or Trust.* The AGI of an estate or trust is determined under §67(e). AGI is computed the same as for an individual except that deductions are allowed for charitable contributions, the personal deduction, distributions to beneficiaries, and costs "which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if property were not held in such trust or estate." Therefore, expenses that cannot be deducted because they are subject to the 2% floor may not be subtracted in arriving at AGI. To the extent that such expenses that are otherwise subject to the 2% floor exceed the 2% floor, they may be deducted in arriving at AGI.

Accordingly, a significant factor in determining how much of the income of an estate or trust will be subject to the high rate bracket rates under ATRA and the Medicare tax depends upon whether costs are those kinds of expenses that are subject to the 2% floor (i.e., commonly incurred by individuals under the reasoning of the *Knight* case), and on the amount of charitable deductions and distributions to beneficiaries. (In addition, costs that are subject to the 2% floor [i.e., because they are "commonly incurred" by individuals] are AMT preference items, even to the extent that they exceed the 2% floor.)

Grantor Trusts. The Medicare tax is not imposed on grantor trusts, but items of income, deduction or credit are treated as if they had been received or paid directly by the grantor for purposes of calculating that person's individual net investment income. Prop. Reg. §1.1411-3(b)(5). See Item9. i(1) below for further discussion of grantor trusts.

c. *Undistributed Net Investment Income*. This term is not defined, but presumably means the net investment income minus distributions. The proposed regulations add that there is no subtraction for distributions of income that are not included in net investment income. Therefore, distributions comprised of both net investment income and "net excluded income items" will require a proration.

Distributions reduce both AGI and net investment income.

Net investment income includes gross income from interest, dividends, rents, royalties, annuities, gains from the disposition of property, passive activities (i.e., not including income derived in the ordinary course of a trade or business), less "properly allocable" expenses. §1411(c)(1). Several types of income are specifically excluded from that investment income, including (i) distributions from IRAs in qualified plans, (ii) non-passive trade or business income, (iii) tax-exempt income and tax-exempt annuities, and (iv) guaranteed payments from partnerships.

The non-passive trade or business income exception requires that (1) there be an activity that involves a trade or business (within the meaning of §162) and (2) is a passive activity within the meaning of §469, which requires material participation by the taxpayer (however, there is no passive activity requirement if the trade or business is trading financial instruments or commodities). Prop. Reg. §1.1411-5(a-b). Thus, generally there must be *both* (1) a trade or business, and (2) material participation by the taxpayer. (See subparagraph h below for more discussion of the passive activity requirement.) There is no separate definition of a "trade or business" in the Medicare tax rules other than applying the principles of §162. As an example, if real estate that is used in a business is held in a separate entity from the operating company, such rental income will not be trade or business income (unless the real estate company is in the trade or business of leasing multiple similar real properties).

As a general rule, most of the income of estates and trusts will be net investment income.

d. *Rental Income*. Rental income is generally passive for purposes of the Medicare tax. There is an exception for real estate professionals that devote 750 hours to working in the real estate business. Otherwise, taxpayers must meet two tests to be for rent to be excepted from being net investment income: (i) material participation, and (ii) the rental income activity is a trade or business.

Self-Rental Rule. If property is rented individually to a closely held business, the rental income is is treated as active income so it cannot be offset by passive deductions for income tax purposes. However, for Medicare tax purposes, self-rental income is passive (and therefore subject to the 3.8% tax). (This may suggest reorganizing entities to move the property producing rental income into the LLC or S corporation, and not have rent charged to a separate entity. However, this depends upon the amount of rent involved and whether the 3.8% tax is enough to override the non-tax reasons for keeping real estate in separate entities.)

e. *Allocating Expenses*. Expenses are first allocated directly to the income item that gave rise to the expense. For example, expenses attributable to rental property must be allocated against rental income. For indirect expenses, however, the regulations under §652 allow the fiduciary to allocate them any way desired. Accordingly, indirect expenses can be allocated against income that would otherwise be subject to the 43.4% maximum rate leaving the capital gains and dividends to be taxed at 23.8%. (Tax preparation software will not do this typically. The preparer will need to override the software output to make such special allocations of indirect expenses.)

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

There is a special rule for capital gains from pass-through entities. Capital gain allocated to the trust on the Schedule K-1 of a partnership or LLC is permitted to pass through to the beneficiaries.

g. *Distributions*. Distributions from an estate or trust may reduce the income subject to the top 43.4%/20% rates on ordinary and capital gains income, respectively, as well as reducing the income subject to the 3.8% Medicare tax. *See* Morrow, *Avoid the 3.8 Percent Medicare Surtax*, TR. & ESTS. 32 (Dec. 2012). Thus, distributions to beneficiaries can save 4.6% or 5% of income tax, depending on whether the income is ordinary income or capital gain, if the individual beneficiary is not in the top tax bracket ($450,000/$400,000). In addition, distributions can save the 3.8% Medicare tax if the beneficiary does not have AGI exceeding the $250,000/$200,000 threshold. The total tax savings could be 8.4%-8.6%, and the savings may be even greater if there are state income taxes.

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

h. *Passive Income*. Passive income is included in both AGI and net investment income. Individuals can use one of seven tests (one of them being the 500 hour rule) to establish material participation to avoid passive income treatment. Passive activity rules for trusts and estates have never been written. The IRS position is that trusts and estates are not treated as individuals for this purpose (so, for example, the 500 hour rule does not apply). The IRS position is that the *trustee* must be involved directly in the operations of the business (in the boots, in the mud on the cattle ranch, walking the ranch on a continual basis, etc.). In the *Mattie Carter* case, the trust operated active ranch operations, and the trustee hired a ranch manager (who was not a trustee). The IRS maintained that was not material participation for the trust because the trustee individually did not materially participate. However, the District Court concluded that material participation should be determined by reference to all persons who conducted the business on the trust's behalf, including employees as well as the trustee. *Carter v. United States*, 256 F. Supp.2d 536 (N.D. Tex. 2003). The IRS non-acquiesced.

Technical Advised Memorandum 2000733023 provides that merely labeling a person involved in the business as a "special trustee" will not suffice. The determining factor is whether the special trustee had powers that could be exercised solely without the approval of another trustee. If so, material participation of the special trustee would suffice.

If a trust owns an interest in an active trade or business operation, a planning consideration will be whether to name some individual who is actively involved in the business as a co-trustee. If that is done, income attributable to the business would not be subject to the 3.8% Medicare tax.

i. *S Corporation Stock and Subchapter S Trusts—Grantor Trusts, QSSTs and ESBTs.*

(1) *Grantor Trusts*. Grantor trusts are qualified S corporation shareholders. The Medicare tax does not apply to grantor trusts (but the net investment income from the trust is treated as owned by the grantor, and will be taxed based on the grantor's individual threshold ($250,000/$200,000)). Prop. Reg. §1.1411-3(b)(5).

A common estate planning strategy involves the transfer of S corporation stock to grantor trusts. If the client materially participates in the business of the S corporation, income from the S corporation should not be a passive activity as to the client, and would not be subject to the Medicare tax. If a parent transfers S corporation stock directly to children (not in grantor trusts), and if the parent materially participates in the business but the children do not, the parent's portion of the S corporation income will not be subject to the Medicare tax, but the children's portion will be (but tested against the children's threshold ($250,000/$200,000)).

(2) *QSST*. A qualified subchapter S trust (QSST) must pay all of its income each year to the sole beneficiary of the trust. Therefore, the trust has no income taxed at the trust level (at the highest marginal rates after only $11,905 of taxable income), and no Medicare tax. The beneficiary would have net investment income from the trust distributions, and the Medicare tax would apply to the beneficiary if the beneficiary has AGI in excess of the individual threshold ($250,000/$200,000). For purposes of both the high marginal income tax rate applied to trusts and the Medicare tax low threshold for trusts, QSSTs are treated very favorably.

(3) *ESBTs*. The Medicare tax proposed regulations have very detailed rules with a detailed example for electing small business trusts (ESBTs). Prop. Reg. §§1.1411-3(c)(1), 1.1411-3(f)Ex.3. All S corporation income of an ESBT is taxed at the trust level, even if distributed. Accordingly, the highest marginal rate and the 3.8% Medicare tax will apply if the trust has taxable income in excess of $11,950 in 2013. However, if the trust's interest in an S corporation constitutes an active trade or business of the trust and the trust meets the passive activity rules (i.e., the trustee meets the material participation requirement), income from the S corporation would not be net investment income subject to the 3.8% tax. Query whether distributions from the ESBT with an "active" interest in an S corporation would be tested at the beneficiary level as net investment income of the beneficiary (depending upon whether the individual materially participated in the business), subject to the individual thresholds ($250,000/$200,000), even though there is no Medicare tax at the trust level?

(4) *Sale of S Corporation Stock*. A sale of S corporation stock (or a partnership interest) is not subject to the net investment income tax if (1) the entity is engaged in a trade or business not relating to the trading of financial instruments or commodities and (2) the transferor is engaged in at least one trade or business of the entity. The portion of the gain excluded from net investment income generally will be the portion of the total gain that is attributable to an active trade or business of the entity. (A rather complicated four-step adjustment process is applied to determine the excluded portion. Prop. Reg. §1.411-7(c).)

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

k. *Fiscal Year Selection.* Estates and "qualified revocable trusts" that make the §645 election may elect a fiscal year, which must end the last day of the month with the first year not extending beyond 12 months.

November 30 Fiscal Year Selection. For decedents dying in 2012, November 30 will be the optimal fiscal year selection in most circumstances for purposes of avoiding the higher income tax rates that apply to trusts and estates with taxable income over about $12,000 under ATRA and for purposes of avoiding the 3.8% Medicare tax -- because the higher rates and the Medicare tax applies to taxable years *beginning after* December 31, 2012. Using a fiscal year of November 30 means that none of the 2012 income, and none of the 2013 income through November 30 would be subject to the higher ATRA rates or the Medicare tax. However, to achieve this advantage, there could not be any distributions during that year to high income taxpayers. (Any distributions would "carry out" the income to the beneficiary in 2013, and would be subject to the higher rates and Medicare tax at the individual beneficiary level — and the individual may be late in making estimated tax payments if the distribution is not made until late in 2013.) One alternative might be to make distributions to beneficiaries who are in lower rate brackets if they need distributions during the year, because they would not be subject to the higher rates or Medicare tax in any event if they do not meet the thresholds. In that case, income attributable to the high income beneficiaries would be taxed to the estate or trust, and the parties would determine under state law whether equitable adjustments can be made so that the beneficiaries have received their portion of income during the year do not have to bear any of the income tax attributable to income that will ultimately be distributed to the high tax bracket beneficiaries who did not receive distributions during the first year.

A fiscal year election is made by selecting a fiscal year on a timely filed return. (A fiscal year stated on a Form SS-4 is not binding. Reg. §1.441-1(c)(1). It appears that a fiscal year may also be claimed on the basis of the books and records for the taxpayer, even if the fiscal year selection is not made on a timely filed return. *See* Reg. §1.441-1(b)(1)(iv).) For a November 30 fiscal year, the initial return due date is due March 15, and a timely return must be filed by that date to elect the November 30 fiscal year.

l. *65 Day Rule.* Under the 65 day rule, the fiduciary may elect to treat distributions made during the first 65 days following the close of the taxable year as if they had been made on the last day of the prior year. §663(b).

For an estate or trust that is on a calendar year, making the 65 day rule election in 2013 may not be desirable. To avoid the high rates that apply to high income taxpayers under ATRA and to avoid the 3.8% Medicare tax, distributions may be more helpful if they are treated as made in 2013 rather than 2012 if the distributions push the taxable income and net investment income among multiple beneficiaries, each of whom have higher thresholds, than subjecting income to taxation at the trust or estate level (with its very low $11,950 taxable income threshold for the high rates and Medicare tax).

m. *Funding Pecuniary Bequests.* If a pecuniary bequest is funded with appreciated property, the post-death appreciation will be taxed as capital gain to the estate or trust, subject to the 3.8% Medicare tax as well as the 20% capital gains tax (assuming the estate or trust has taxable income in excess of $11,950 in 2013). In retrospect, it would have been better to fund the pecuniary bequest in 2012.

10. Strategies to Preserve Basis Adjustment Upon Grantor's Death

Some of the information in this Item is based, often verbatim, on information from Ellen Harrison, Washington, D.C. Because of the permanent $5 million indexed estate tax exemption, many estates will have no federal estate tax concerns, but may be much more concerned with assuring that the assets will receive a step up in basis at the owner's death.

A further extension of this planning would be to leave the flexibility of causing the trust assets to be included in the donee's estate for estate tax purposes if there are no estate tax concerns for the donee and if a basis step up at his or her death would be desirable. These are the same strategies as discussed in Item 12 below.

a. *Repurchase of Appreciated Asset for Cash or High Basis Property (Not a Note).* Assets with substantial appreciation that have been transferred to a grantor trust could be repurchased by the grantor before death. Most conservatively, the grantor should use cash to repurchase the assets.

If the donor does not have sufficient other assets, repurchase will be difficult. One alternatively would be for the grantor to borrow funds from an outside lender, and use the cash proceeds to purchase the appreciated assets. The loan could be repaid following the grantor's death.

There is uncertainty regarding the income tax consequences if a note is used to repurchase property from the grantor trust. The trust's basis in the note may equal the grantor's basis in the reacquired asset so that the payment of the trust's note would ultimately generate gain.

An obvious difficulty with this strategy is that the repurchase must occur prior to the death of the donor, but the date of death is unpredictable. Standby purchase instruments might facilitate fast implementation of the repurchase transaction.

Section 1014(e) may apply if the purchase is from a grantor trust owned by the spouse and therefore treated as a gift under §1041.

b. *Using Freeze Partnership.* A donor may make a gift of the common interest while retaining the preferred interest in a preferred partnership. The common interest would be valued at an amount at least equal to 10% of the partnership value. The effect is to transfer cash flow and appreciation in excess of the preferred return and liquidation preference of the retained preferred interests.

The preferred interest will be structured to satisfy the §2701 requirements (which, among other things, would require a cumulative return), so that the retained preferred interest is not valued at zero for gift tax purposes.

The preferred interest would be includable in the gross estate at death and would be eligible for a basis step up. The key, for basis purposes, is that a §754 election would allow a corresponding step up to the partnership's inside basis in underlying assets.

This structure requires the payment of a preferred return to the donor, which may be difficult if the yield under on the underlying assets is not sufficient.

Charitable Planning. Preferred partnership interest can also be useful for charitable planning. The client may give some of the preferred interest to a donor advised fund. The par value of the preferred interest does not have to be paid until the partnership terminates. Instead of making a bequest to charity, for which no income tax deduction would be permitted, the client would receive a current income tax deduction for the fair market value of the preferred at the time that it is transferred to charity. In addition, the client is not taxable on the coupon that is paid to the charity (either for income tax purposes or for purposes of the Medicare tax. (In effect, a deduction is allowed for Medicare tax purposes.)

c. *Intentionally Busted §2701 Transaction*. A donor would make a gift of a common interest in a partnership/LLC while retaining a preferred interest that does not meet the requirements of §2701. The effect under §2701 is that the preferred interest is treated as having a zero value (for example, because it is noncumulative). The donor would be treated under §2701 as making a gift equal to the donor's entire interest in the entity. (The donor would need to have remaining gift exemption equal to the value of the entity to avoid having to pay gift tax.)

At the donor's death, the value of the preferred interest is includable in the gross estate. A put right would assure that the value will be at least equal to the liquidation preference if the preferred payment right is noncumulative. Thus, a basis step up should be permitted equal to that value. There is no transfer tax on the income and appreciation to the extent it exceeds whatever the donor receives (if anything) in preferred payments. The mitigation rule in Reg. §25.2701-5(a)(3) makes the zero value rule less significant since the donor's estate will be reduced by the same amount by which the gift value was increased due to the zero value rule.

Ellen Harrison provides the following example of how this strategy would work.

- The gift of the common interest is valued as if the preferred interest retained by the donor had a zero value if the preference is noncumulative. Assume the preference is $5MM and the value of the common would be zero if §2701 did not apply (because the assets owned by the entity are only $5MM) but because §2701 does apply the gift is assumed to be $5MM.
- All dividends and appreciation in excess of the preferred return belong to the common shareholders, partners or members because that is what the document says. That is, upon liquidation the preferred gets its preference and any additional value goes to the common. Assume that no dividend is declared during the donor's lifetime (although

this doesn't matter, presumably dividends would be declared only if the donor needs the funds, but no dividends could be paid to the common until the preference was paid for a particular year) so earnings accumulate.

- Donor dies and the value of the preferred is included in the estate of the donor and the preferred gets a basis adjustment equal to its then fair market value. The value cannot exceed the liquidation preference (presumably no value would be attributed to the right to dividends because they are noncumulative); §2701 should not apply a second time since there is no transfer occurring at death.
- Under Reg. §25.2701-5(a)(3), "the amount on which the decedent's tentative tax is computed under section 2001(b)" is reduced by the amount by which the gift was increased because of the zero value rule. Thus, the value in the gross estate is not impacted, but merely for purposes of calculating the estate tax, a reduction is allowed for the amount by which the taxable gift was increased because of §2701. If the value of the preferred at the time of the gift was reduced from $5MM to zero and if the value of the preferred at the time of death is still $5MM, the estate tax base on which tax is calculated is reduced by $5MM (and in our example nets to zero). This adjustment would not affect the income tax basis because this adjustment does not change the amount included in the gross estate; it is merely a factor considered in calculating the estate tax.

d. *Allocation of Partnership Debt Under §704.* For assets subject to liabilities in excess of basis ("negative basis assets"), step up is particularly important. The client would fund a partnership (a real partnership, not a disregarded entity) with property subject to a liability in excess of basis. The nonrecourse liability is specially allocated to the contributing partner. If the other partner is an LLC owned 99% by the client and 1% by another person, so that neither the LLC nor the partnership is a disregarded entity, the client can gift interests in the LLC to children without disturbing the special allocation of the liability. At death, the partnership basis rules provide that the client's estate receives a basis equal to the value of the client's share of equity plus liabilities assumed. Although the net value in the estate is low, because of the liability, the client's estate receives a full basis step up.

This strategy is very advantageous economically because the spread between the estate and income tax rates has decreased. This is a way of both transferring appreciation and still getting the benefits of a basis step up.

e. *Triggering Estate Tax Inclusion.* Because of the permanent large indexed estate tax exemption, the client who will not have to pay any federal estate tax may want to take steps purposefully to cause previously transferred assets to be included in the gross estate in order to receive the basis step up.

(1) *How.*

- The trustee (or some other party) may have discretion to grant the settlor a limited power of appointment. The limited power of appointment could be as broad or narrow as desired, as long as it allowed the possibility of shifting benefits from one beneficiary to another. If so granted, this would cause inclusion in the grantor's estate under §2038 (and that section is based on powers that the grantor actually holds at death and not on the retention of interests at the time of the original transfer). To protect the independent third party, the instrument might exonerate the independent party from liability with respect to the decision to grant the power of appointment regardless of whether it is exercised. The instrument could provide that the independent third party has no obligation to inquire as to whether the authority should be exercised. Another approach would be to provide that the independent party has no authority to grant the power of appointment until requested in writing to do so by a designated class of persons.

- A formula power of appointment in the trust agreement may cause estate inclusion in desired circumstances. The grant of the testamentary power of appointment to the grantor could conceivably be by a formula. The trust instrument could give the donor a formula testamentary power of appointment to the extent that an amount equal to 40% of the excess of the date of death value over the date of gift value is less than an amount equal to 23.8% (i.e., 20% capital gains rate + 3.8% Medicare tax on net investment income) of the excess of the date of death value over the basis of the property (substituting the current tax rates). The disadvantage of the formula approach, if it operates immediately after the creation of the trust, is that it creates an ETIP, which would preclude immediate allocation of GST exemption to the trust. (See Item 12.c below.)
- Moving from an asset protection jurisdiction to jurisdiction in which the grantor's creditors can reach the assets may cause estate inclusion. (See Item 15.d below.)
- The estate may take the position that there was an implied agreement of retained enjoyment. For example, the parent may continue living in the house in a QPRT or other trust to which a residence was transferred without paying rent to trigger § 2036(a)(1). However, the IRS conceivably may not take the position in that type of circumstance that the failure to pay rent, based on the changed circumstances, reflects an implied agreement to retain the interest at the outset (which is a requirement under § 2036(a)(1)). As another example, if a parent has given undivided interests in a vacation home to children, the parent may start using the vacation home exclusively without paying rent in a similar attempt to trigger an implied agreement of retained enjoyment under § 2036(a)(1).

(2) *Why.*

- The income tax cost of the loss of basis step up outweighs the estate tax savings because appreciation is not sufficient. See Item 12.c below.
- The gifted property declines in value so it is desirable to exclude the gift from adjusted taxable gifts under §2001(b).

(3) *Tax Consequences.*

- The value of property at death is includable in the gross estate.
- Adjusted taxable gifts do not include gifts that are includable in the gross estate (§2001(b)), but no reduction is available for gifts treated as having been made by the spouse because of a split gift election.

- How much is excluded from adjusted taxable gifts where less than all of the cumulative value attributable to the gifted property is includable in the estate (e.g., because of distributions of income or distributions of appreciation)? (This type of strategy is described in Item 25.)

11. Strategies to Preserve Basis Adjustment Upon Surviving Spouse's (or Other Donee's) Death

If a trust is created for the surviving spouse at the decedent's death (for example, in a standard credit shelter trust), the estate tax may not be a concern at the surviving spouse's subsequent death, and building in flexibility to allow a step up in basis at the spouse's death is important. These strategies also apply if a parent makes transfers and wants to leave the flexibility for the donees to obtain a basis step up if their estates subsequently have no estate tax concerns.

a. *Basis Step Up Flexibility; Broad Distribution Powers*. One method of causing estate inclusion if the surviving spouse has no estate tax concerns (which might occur, for example, because of indexing of the estate tax exclusion amount over a long term of the surviving spouse's subsequent lifetime) is to give the independent trustee broad authority to make distributions to the surviving spouse, 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 surviving spouse and other possible disadvantages are mentioned in the following paragraph.

b. *Basis Step Up Flexibility; Independent Party With Power to Grant General Power of Appointment.* The trust agreement could give an independent party the power to grant a general power of appointment to the surviving spouse. It could be a power exercisable only with the consent of a non-adverse party if the settlor wishes to place some controls over the surviving spouse's unbridled ability to redirect where the assets will pass. The power could be limited to the ability to appoint the assets to the surviving spouse's creditors. Howard Zaritsky points out that he prefers this approach to the broad distribution powers approach. Making physical distributions to the spouse may be mechanically cumbersome, particularly in a deathbed situation. 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. The surviving spouse 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.

c. *Basis Step Up Flexibility; Formula General Power of Appointment.* The general consensus is to discourage the use of formula general powers of appointment granted to the extent that the power would not result in the payment of estate taxes. There is concern that the beneficiary could have indirect control over all of the trust assets as a result of the formula grant of the power, meaning that the beneficiary would have a general power over all of the trust assets for tax purposes. If the formula operates without regard to the availability of a marital or charitable deduction, the formula no longer accurately grants a general power to cause basis step up even though there would be no estate tax.

d. *Basis Step Up Flexibility; Delaware Tax Trap.* Another alternative to leave the flexibility to cause inclusion in the beneficiary's estate is to use the "Delaware tax trap." Delaware law at one time (perhaps still) provided that if someone exercises a power of appointment to grant a presently exercisable power of appointment to another person, even a *limited* power of appointment, that grant of the new power is treated as a vesting of property for purposes of the rule against perpetuities. The original power could be exercised to appoint the assets in further trust, with a new perpetuities period running from the date of exercise, which means that the trust could be extended indefinitely without having the assets subjected to estate tax. Sections 2041(a)(3) and 2514(d) were enacted to prevent avoiding the estate tax indefinitely by successive exercises of limited powers of appointment and creating new powers in other persons of new presently exercisable limited powers of appointment. Section 2041(a)(3) provides that property subject to a non-general power of appointment (which would generally not cause inclusion under § 2041) will cause estate inclusion under that section if the power holder exercises the power of appointment "by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power."

Under the law of most states, exercising a power of appointment by creating a new presently exercisable *general* power of appointment in another person is treating as vesting the property in the new power holder because he or she could exercise the power to appoint the property immediately to him or herself. If the new power holder were to appoint the property in further trust, the perpetuities period on the new trust would run from the time of the exercise creating the new trust. Therefore, at the time the original power holder granted a new presently exercisable general power of appointment, § 2041(a)(3) would be triggered because the new power could be exercised in a way that the vesting of the property in anyone else could be postponed for a period longer than the perpetuities period that applied originally (i.e., "for a period ascertainable without regard to the date of the creation of the first power."). For an excellent discussion of the Delaware tax trap and ways of using the concept to cause estate inclusion in a trust beneficiary (in order to avoid the GST tax), see Jonathan Blattmachr and Jeffrey Pennell, *Using "Delaware Tax Trap" to Avoid Generation-Skipping Taxes*, 68 J. TAX'N 242 (April 1988).

Accordingly, using the Delaware tax trap is one way to cause inclusion in the surviving spouse's (or any other beneficiary's) gross estate, if the beneficiary would not owe estate tax in any event because of the estate tax exemption and the beneficiary would like to obtain a step up in basis on the trust assets at his or her death. All that must be done to leave open the flexibility of using the Delaware tax trap is for the trust to give the beneficiary a limited power of appointment that includes the power to grant new presently exercisable powers of appointment. (The power to appointment in further trust would generally include this authority.) The decision of whether to trigger estate inclusion in the beneficiary's gross estate is then totally up to the beneficiary. If the beneficiary wants to trigger estate inclusion, the beneficiary would exercise the original power to create a presently exercisable general power of appointment in someone else. That would cause estate inclusion in the original power holder's gross estate under § 2041(a)(3).

A negative aspect of causing estate inclusion in that manner is that the assets would also have to be included in the successor power holder's gross estate as well (because the second power holder would hold a general power of appointment).

Being able to use the Delaware tax trap in statutes that have abolished their rule against perpetuities is more complicated. In that situation, a possible strategy suggested by some planners is to provide that the original trust lasts for 1,000 years, but that the power can be exercised to create a trust that could last for 1,000 years after the power is exercised. In this manner, the vesting of the property could be postponed for a period "ascertainable without regard to the date of the creation of the first power."As an example, Steve Gorin, an attorney in St. Louis, Missouri, suggests using the following clause in a state that has abolished its rule against perpetuities:

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

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

e. *Basis Step Up Flexibility For Spousal Transfers*. If the surviving spouse (or other donee) makes transfers, the planning strategies in Item 10 above may be utilized to provide basis adjustment flexibilities with respect to those transfers.

12. General Gift Planning Issues for 2013 and Beyond

a. *Overview of Tax Effects of Gifts*. The following is a brief summary of the tax effects of gifts.

- A donor can make gifts of the full additional gift exemption amount without paying gift tax. Cumulative lifetime taxable gifts above the exemption amount are subject to a 40% gift tax.
- Gifts are not removed from the base for calculating estate tax, but making gifts does not result in increasing the aggregate combined transfer taxes.
- Despite the fact that gifts are included in the base for calculating the estate tax, tax advantages of making gifts include:
  - removal of appreciation/income of gift assets from the gross estate;
  - utilizing fractionalization discounts;
  - paying income taxes on income from grantor trusts to further "burn" the donor's gross estate;
  - if the donor lives three years, gift taxes paid are removed from the gross estate (after exemptions have been used, giving $100 costs $40 of gift tax but bequeathing $100

costs $66.67 of estate tax, see Item 12.e below for further discussion of this opportunity);

- the ability to allocate GST exemption so that the same advantages apply for generation-skipping purposes as well; and
- removing assets from the donor's gross estate for state estate tax purposes without payment of any federal or state transfer taxes (assuming the state does not have a state gift tax or "contemplation of death" recapture of gifts back into the state gross estate).

- The most obvious non-tax advantage of making gifts is to allow donees to enjoy the gift assets currently.
- **Perhaps the most important advantage of the increased gift exemption for many individuals will be the "cushion" effect** — the ability to make gifts in excess of $1 million, but considerably less than $5 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even if "aggressive" valuations are used), which may lessen the perceived necessity to use defined value clauses to avoid paying gift taxes in making transfers. Planners have indicated that some 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, have completed transfer planning transactions after 2010 in light of the cushion effect of the $5 million gift exemption.
- Gifts can be disadvantageous from an overall tax cost perspective if (i) if the loss of a basis step up more than offsets the estate tax savings as a result of removing appreciation/income from the asset and the other advantages of gifts listed above, or (ii) the gift asset declines in value after making the gift (which uses up gift exclusion based on the date of gift value). However, the depreciating asset disadvantage generally applies only for gifts using the unified credit. For gifts that will incur a gift tax, the beneficiaries may still be better off in a depreciation scenario assuming the assets are invested the same way and they are in the same income tax brackets. For example, a client who has used his full exemption and has a portfolio worth $100 could give $71.4 to his children today and pay $28.6 (40%) gift tax. If the portfolio drops in value by 50%, the children are left with $35.7. If he had kept the assets until death, the assets would have dropped in value to $50, and after estate taxes his children would receive $30. Even with the depreciation, the gift was better if the donor lives three years. In addition, there may be lifetime discounting opportunities. The exceptions would be if the gifted assets depreciated and the donor sold a different class of assets to pay the gift tax and those assets would have performed better than the assets he gave away, or if tax rates are reduced.

b. *Exemption Amount Increased for 2013*. The gift/estate/GST exemption amount is indexed. It increased to $5,120,000 for 2012 and to $5,250,000 for 2013. In addition the gift tax annual exclusion increases to $14,000 in 2013.

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

Example: A gift is made of a $1 million asset with a zero basis. If the asset does not appreciate, the family will lose the step up in basis, and at a 20% rate (if the family members are in the top tax bracket), this means the family will receive a net value of $800,000 from the asset (after it is sold). If the asset is not gifted, the transfer tax implications are the same but the step up in basis saves $200,000. The asset would have to appreciate to from $1,000,000 to $2,000,000 (**100%!!**) in order for the estate tax savings on the appreciation to offset the loss of basis step up (i.e., $1,000,000 post-death appreciation x 0.40 = 2,000,000 total appreciation (assuming zero basis) x 0.20[assuming the donee is in the top income tax bracket]).

Furthermore, if the donee has enough taxable income to be in the top income tax bracket, the donee will satisfy the AGI threshold to be subject to the 3.8% Medicare tax on net investment income, so the asset must appreciate by $1,469,136 (from $1.0 million to 2.469 million), or by almost **147%!!** ($1,469,135 x .40 = $2,469,135 x .238) before the estate tax savings will outweigh the loss of a basis step up.

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

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

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

Strategies are available to avoid the loss of basis step up if gifts are made to grantor trusts. The grantor can repurchase the low-basis assets before death, so that the low-basis assets would be in the gross estate at death and get a step up in basis under §1014. (This could be worthwhile even if the grantor has to borrow money to be able to repurchase the low basis assets and get cash into the grantor trust — which does not need a stepped-up basis.) In addition, some commentators maintain that a basis step up is available under §1014 at the grantor's death for all assets in a grantor trust. *E.g.,* Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death,* 97 J. TAX'N 148 (Sept. 2002). See Items 10-11 above for further discussion of strategies to preserve basis step up at the taxpayer's death.

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

e. *Sample Specific Gifting Strategies.* Possible gifting strategies in an environment of a large $5 million indexed gift exemption include the following:

- Gifts to Dynasty trust to utilize $5 million 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;
- GRATs (GRATs will continue to be advantageous even with the permanent $5 million indexed gift exemption);
- Life insurance transfers (including the ability to "roll out" of split dollar arrangements);
- Deemed §2519 transfers from QTIP trusts (for an outstanding detailed discussion of planning by a surviving spouse with QTIP trusts, see Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 ¶ 1202.3 (2010));
- QPRTs;
- Gifts to same-sex couples; and
- Make a large gift requiring payment of gift tax, to reduce the estate tax if the donor survives three years (after exemptions have been used, giving $100 costs $40 of gift tax but bequeathing $100 costs $66.67 of estate tax; this opportunity is more realistic now that we have "permanent" transfer tax provisions and the possibility of repeal has receded; if the client wants to give particular assets in excess of the gift exemption amount but wants to minimize gift taxes payable currently, consider using financed net gifts as explained at Handler, *Financed Net Gifts Compared to Sales to Grantor Trusts,* 44th UNIV. MIAMI INST. ON EST. PLAN. ch. 17 (2010)).

These specific gift strategies are discussed in more detail at Item of the 2012 Heckerling Musings at http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/01_2012_Heckerling%2520Summary.html

f. *Lapsing General Power of Appointment Held by Person With Modest Assets to Utilize That Person's GST Exemption.* In making a gift to a trust for descendants, consider providing that the client's parent would be a discretionary beneficiary (together with the client's issue) and that the parent would have an inter vivos general power of appointment over the trust, which will lapse at some point in the current year. The lapse of the general power of appointment is treated as a gift by the parent, but the parent's $5 million indexed gift exemption would fully cover the gift. No estate tax concerns would arise at the parent's death if the parent's other assets, even when added to the gift amount, would not be sufficient to cause the estate tax to apply at the parent's death. (***Having a "permanent" $5 million indexed estate tax exemption makes this strategy realistic.***) When the parent makes a transfer subject to transfer tax, the parent is treated as the transferor of the trust for GST purposes (§2652(a)(1)), and the parent could allocate his or her GST exemption to the trust. In that situation, the parent should not continue as a beneficiary of the trust after the lapse of the general power of appointment if the trust is not created in a "self-settled trust state", or else the parent's creditors might be able to reach the trust assets which might cause inclusion in the parent's estate under §2036(a)(1) and cause an ETIP, which would preclude the parent from being able to allocate the parent's GST exemption until the end of the ETIP.

13. Gift Strategies That Provide Some Benefit to Grantor and/or Grantor's Spouse — Overview

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

- Borrowing of trust funds by grantor;
- Spousal limited access trust ("SLAT") and/or exercise by beneficiaries of special powers of appointment;
- "Non-reciprocal" trusts;
- Self-settled trusts established in asset protection jurisdictions;
- Sale for a note or annuity rather than making a gift of the full amount to be transferred;
- Transferring residence to trust or co-tenancies between grantor/spouse of grantor and trust;
- "Reverse defective grantor trust" transaction in which the donor purchases (including through the exercise of a substitution power) or borrows assets gifted to trust;
- Preferred partnership freeze;
- Turning off grantor trust status (to at least minimize the continuing cost to the grantor);
- Payment of management fees to the grantor;
- Inter vivos QTIPable trust; and
- Retained income gift trust.

Each of these alternatives is discussed in more detail in Items 14-24 below.

14. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Borrowing From Trust

A very simple way of dealing with the desire to keep a "back-door" for cash flow from the trust in the event of a financial reversal is that the donor could request a loan from the trustee of the trust. The trustee, subject to fiduciary duties, will likely want to require appropriate interest (perhaps greater than the AFR) and collateral for the loan. The donor may want a stronger method of a possible "back-door" to the assets, but if the loan alternative is sufficient, that is a clean and simple solution.

If the loan is bona fide indebtedness, the donor's estate may be entitled to an estate tax deduction for the outstanding liability if the loan has not been repaid prior to the decedent's death. *But see Estate of Holland v. Commissioner,* T.C. Memo 1997-302 (citing various factors mentioned in prior cases regarding loan vs. equity cases to conclude that the estate did not owe bona fide indebtedness that could be deducted under §2053).

15. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Lifetime Credit Shelter Trust for Donor's Spouse (also referred to as Spousal Lifetime Access Trusts, or "SLATs"); Exercise of Powers of Appointment for Grantor and/or Grantor's Spouse

The donor may wish to make gifts in a way that the donor (or the donor's spouse) could retain some use of the assets in case needed as a "rainy day" fund. A popular way of using the increased gift exemption may be for a donor to make gifts to a "lifetime credit shelter trust" for the benefit of the donor's spouse (and possibly children). The trust could be designed to give as much control and flexibility as possible to the surviving spouse without creating tax or creditor concerns.

a. *Overview of Major Issues.* Ellen Harrison suggests the following major issues in planning SLATs.

    - Avoid the reciprocal trust issue by making only one spouse a beneficiary, at least initially.

- Using a SLAT prevents gift splitting if the spouse's interest is not severable, ascertainable, and de minimis.
- The SLAT provides a benefit only while the donee spouse is living and married to the grantor.
  - Consider an agreement of the spouses that the gift will be taken into consideration in any property settlement incident to a divorce.
  - Consider life insurance on the donee-spouse in case the donee-spouse dies before the grantor.
  - Give the donee-spouse a limited testamentary power of appointment exercisable in favor of the grantor (but carefully consider §2036 and creditors' rights against the donor before the donee-spouse exercises the power of appointment).
  - The grantor may exercise a power of substitution (e.g.., for a long-term AFR note) if the parties divorce so that the donor would have the ability to re-acquire favored assets in the trust.
- The step transaction doctrine may treat the donee-spouse as a grantor if transfers were made by the grantor to the donee-spouse shortly before the trust was funded.
- If the SLAT is funded by the grantor with a residence, can the grantor reside in the residence without paying rent? (Presumably yes, under the reasoning of various §2036 cases that a donor's continuing to live with his spouse is not considered an implied agreement of retained enjoyment.) If the donor pays rent, is it a gift? (Presumably not.)

b. *Trust Terms*. The trust would be for the benefit of the donor's spouse, containing very similar terms as in standard credit shelter trusts created in wills. The trust may allow very broad control to the spouse but still not be included in the spouse's estate for estate tax purposes and may be protected against claims of both the donor's and spouse's creditors. In some ways, this is the ideal kind of trust for the spouse.

Possible terms could include:

- Spouse as a discretionary beneficiary (perhaps with children as secondary beneficiaries)
- Spouse as trustee (distributions to the spouse would be limited to HEMS)
- Provide that no distributions could be made that would satisfy the donor's legal obligation of support (and if distributions are made to the donee-spouse, preferably the spouse should use those distributions for things other than basic support needs to remove any inference that the funds are actually being used for the settlor's benefit)
- Spouse could have a "5 or 5" annual withdrawal power
- Spouse could have limited power of appointment (exercisable at death or in life)
- In case the donee-spouse predeceases, the power of appointment could be broad enough to appoint the assets back to a trust for the donor. (Exercising the power of appointment in the donee-spouse's will to include the donor-spouse as a discretionary beneficiary should not cause inclusion in the donor-spouse's estate under §2036(a)(1) if there was no pre-arrangement, but that might not prevent the donor-spouse's creditors from being able to reach the trust assets unless the trust is created in a self-settled trust jurisdiction. Several states (Arizona, Delaware, Florida, Michigan and Wyoming) have passed statutes addressing this situation for inter vivos QTIP trusts, providing that such an appointment in trust for the donor-spouse would not cause the trust assets to be

subject to the donor-spouse's creditors. The power of appointment should provide that it cannot be exercised in a manner that would grant the original donor a power of appointment over the assets to avoid triggering §2038 inclusion in the donor's estate. See subparagraph c below for further discussion.

- A "trust protector" or some independent party could be given the discretion to add the donor of the trust at some time in the future (perhaps after a number of years or after the donor is no longer married to the donor's spouse at the time the trust is created). There should be absolutely no understanding (or even implied agreement) with the protector as to how the power would be exercised.
- Another way of addressing the donee-spouse predeceasing the donor would be to have some life insurance on the donee-spouse payable to the donor or a trust for the donor-spouse that has substantially different terms than this trust.
- If the donor were concerned about how the donee-spouse might exercise the power of appointment, the instrument could provide that the power of appointment could be exercised by the spouse only with the consent of a non-adverse third party (such as the grantor's sibling), and the instrument could even provide that the third person's consent would be required in order for the donee-spouse to change an exercise of the power of appointment.
- To address the possibility of a divorce, in which event the donor-spouse may not want the donee-spouse to continue as a beneficiary, the trust could define the "spouse" to be the person to whom the grantor is married at the time without causing estate inclusion in the donor's estate. *See Estate of Tully Jr. v. United States*, 528 F.2d 1401 (Ct. Cl. 1976) (power to alter death benefit plan by terminating employment or divorcing wife not a §2038(a)(1) power); Rev. Rul. 80-255, 1980-2 C.B. 272 (including settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change beneficial interests under §§2036(a)(2) or 2038). Therefore, the trust could also be available for the benefit of a new spouse. Also, the donor and donee-spouse may enter into an agreement that the gift will be taken into consideration in any property settlement incident to a divorce.
- If the donor gets to the point that the donor really needs to be a beneficiary of the trust and wants the spouse to exercise the power of appointment, estate taxes may be the least of the donor's concerns.

With this approach, the trust could still be used for the "marital unit" if the client has concerns that large gifts may unduly impoverish the donor and his or her spouse, but the assets would not be included in the gross estates of the donor or the donor's spouse. Such a trust would likely be a grantor trust as to the grantor under §677 (unless the consent of an adverse party were required for distributions to the spouse).

c. *Application of §§2036-2038 If Donee Spouse (or Other Beneficiary) Appoints Assets Into Trust for Benefit of Original Donor Spouse.* This issue is receiving increased attention by planners. The IRS might argue that §2036 could apply in the donor spouse's estate if it could establish an implied agreement that the donee-spouse would leave the donated assets back into a trust for the benefit of the donor spouse. This is analogous to situations in which one spouse makes a gift to the other spouse, and the other spouse bequeaths the property back into a trust for the benefit of the original donor spouse. For a discussion of various relevant cases see Item 5.i(1) of the 2012 Heckerling Musings at http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/01_2012_Heckerling%2520Summary.html

There is a specific exception in the QTIP regulations providing that the §2036/2038 issue does not apply for gifts to an inter vivos QTIP trust, where the assets are left back into a bypass trust for the benefit of the donor spouse. Reg. §§25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11. However, those examples would not apply because the rationale in them is that there will be estate inclusion in the donee-spouse's estate under §2044.

The possibility of a beneficiary exercising a power of appointment for the benefit of the grantor (or grantor's spouse) applies beyond just SLATs. Trusts for descendants or other beneficiaries may grant a beneficiary a power of appointment broad enough to allow appointing the assets to a trust that may be benefit the grantor or the grantor's spouse; the same general issues apply.

Summary of Potential Application of §2038. Section 2038 can apply to an ability to alter, amend, revoke, or terminate that exists in the trust at the death of the decedent — it did not have to be retained at the outset. So in exercising the non-general power of appointment, 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 could not have a testamentary power of appointment by reason of the exercise.

In addition, realize that if creditors can reach the assets in a trust to which assets have been appointed by the donee-spouse under the reasoning of the relation back doctrine (discussed below), that could create a §2038 problem, even if there was no implied agreement of how the donee-spouse would exercise the power of appointment at the time of the original transfer. While various cases that have held that assets in a trust that can be reached by the donor's creditors are in the donor's gross estate under §2036 [*e.g., Estate of Paxton v. Comm'r*, 86 T.C. 785 (1986)], some cases have also suggested that inclusion may also result under §2038. *E.g., Outwin v. Comm'r*, 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §§2036(a)(1) ***or 2038(a)(1)***).

Summary of Potential Application of §2036. The issue is whether the entire transaction and appointment back was pursuant to an implied understanding that these series of transactions would occur. Prof. Jeffrey Pennell's conclusion: "I think, frankly, it would be difficult for the government to make that case, but of course you could leave a trail of documents — a smoking gun — that could allow the government to say this was all part of a prearrangement, and that conceivably could get you into §2036."

d. *Creditor Rights Issue.* A totally separate issue is that, despite the tax rules, for state law purposes the donor to the lifetime credit shelter trust may be treated as the donor of the continuing trust for his or her benefit after the death of the donee-spouse. Therefore, for state law purposes, there is some possibility that the trust may be treated as a "self-settled trust" and subject to claims of the donor's creditors. This would seem to turn on what has been called the "relation back doctrine."Barry Nelson, *Asset Protection & Estate Planning – Why Not Have Both?,* at 15-11 2012 UNIV. MIAMI HECKERLING INST. ON EST. PLANNING ch. 17, ¶ 1701.2[B] (2012) (citing RESTATEMENT (FIRST) AND RESTATEMENT

(SECOND) OF PROPERTY and a 1977 Florida case, concluding "[N]one of the reported cases regarding the Relation Back Doctrine address its application to the donor of a QTIP or credit shelter trust who receives trust assets upon the death of the donee spouse through the exercise of a special power of appointment ….").

See Alexander Bove, *Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined,* 36 ACTEC L.J. 333, 337 (2010) (after discussing the relation back doctrine in this context concludes, "Thus, it is not clear that a court would actually hold that it was a transfer from the donor to a trust for his own benefit through a power holder's discretionary exercise of a power of appointment, but it is a risk"). *See also Watterson v. Edgerly*, 40 Md. App. 230, 388 A.2d 934 (1978)(husband gave assets to wife and next day wife signed will leaving assets to trust for husband; held that the trust was protected from husband's creditors under the trust spendthrift clause).

At least five states have statutes that address this situation in the context of initial transfers to an inter vivos QTIP trust, as opposed to transfers to a lifetime credit shelter trust. Those states are Arizona, Delaware, Florida, Michigan, and Wyoming. The Arizona statute addresses the issue for all inter vivos trusts initially created for the donor's spouse (including the lifetime credit shelter trust strategy discussed in this sub-paragraph) where the assets end up in a trust for the original donor-spouse. ARIZ. REV. STAT. §14-10505(E-F).

Gross Estate Inclusion? If the donor's creditors can reach the trust assets, that would cause inclusion in the donor's estate for estate tax purposes under §2036 *if* the IRS could establish the existence of an implied agreement that the spouse would exercise the limited power of appointment to appoint the assets into a trust for the donor's benefit, which creates the creditor's rights problem. However, at least one case (*Outwin v. Comm'r*, 76 T.C. 153 (1981)) also states that §2038 could apply if the donor's creditors can reach the trust assets, and §2038 does not require an implied agreement of a retained interest at the time the gift is originally made, but only looks to conditions that exist at the donor's death. Accordingly, it may be important to exercise the limited power of appointment to establish a new trust in a "self-settled trust state" or a state that has passed a law similar to the Arizona statute quoted above.

e. *Gift From One Spouse With Split Gift Treatment.* Instead of having each spouse make $5 million gifts, some planners have suggested that one spouse could give the entire $10 million to a trust having the other spouse as a discretionary beneficiary. The other spouse would make the split gift election, which treats him or her as the transferor for gift and GST tax purposes (meaning that the spouse's gift and GST exemption could be used) but NOT for estate tax purposes. Therefore, the assets would not generally be included in the spouse's gross estate for estate tax purposes even though he or she was a discretionary beneficiary. The problem with this approach is that split gift treatment is not allowed if the consenting spouse is a beneficiary of the trust unless the spouse's interest in the trust is ascertainable, severable and de minimis. *See* Rev. Rul. 56-439, 1956-2 C.B. 605; *Wang v. Commissioner*, T.C. Memo 1972-143 (no split gift election allowed where consenting spouse's interest in trust receiving gift assets was not ascertainable); *Robertson v. Commissioner*, 26 T.C. 246 (1956)(gift splitting allowed for full amount transferred); *see generally* D. Zeydel, *Gift-Splitting — A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules*, 106 J. TAX'N 334 (June 2007). Interestingly, Ltr. Rul. 200130030 allowed gift splitting for the full amount of the transfer without discussing the value [in particular, that it had no value] of the donee spouse's severable interest).

For a more complete discussion of the relevant cases and letter rulings, see Item 5.k(3) of the summary at http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/12_2012_Estate%2520Planning%2520Current%2520Developments.html

Gift splitting should be allowed in full if:

- Distributions of both income and principal to the donee-spouse are subject to an ascertainable standard of distribution under §2514, preferably a standard based upon the spouse's accustomed standard of living;
- The trustee must consider other resources available to the spouse before exercising its discretion to distribute income or principal to the spouse; and
- The resources that are, and are expected to be, available to the spouse for the remainder of his or her lifetime are sufficient to meet the spouse's living expenses, such that the likelihood that the trustee will need to exercise its discretion to distribute income or principal to the spouse is so remote as to be negligible.

16. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — "Non-Reciprocal" Trusts

If the "rainy day" concern can be accommodated by having only one spouse make a gift to a trust with the other spouse as a discretionary beneficiary, that is far preferable. The gift by the other spouse would be to a trust with only descendants as beneficiaries. That clearly avoids the reciprocal trust doctrine (although an issue could arise if the spouses serve as trustees of each other's trust). Some clients may want to go further and have each of the spouses create credit shelter trusts for the other spouse; the issue would be whether such trusts could be structured to avoid the reciprocal trust doctrine and therefore avoid estate inclusion in both spouses' estates.

If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated," the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. *United States v. Grace*, 395 U.S. 316 (1969). In *Grace*, the trust terms were identical, the trusts were created 15 days apart, and the trusts were of equal value. The Court reasoned:

> Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the *trusts be interrelated*, and that the arrangement, *to the extent of mutual value*, leaves the settlors in approximately the *same economic position* as they would have been in had they created trusts naming themselves as life beneficiaries. (Emphasis added)

If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *See Estate of Levy v. Commissioner*, 46 T.C.M. 910 (1983); Letter Ruling 200426008; *but see Estate of Green v. United States*, 68 F.3d 151 (6th Cir. 1995)(Jones, J. dissenting).

Possible distinctions that could be built into the trusts include:

- Create the trusts at different times (separated by months, not 15 days as in *Grace*)

- Fund the trusts with different assets and different values (observe that *Grace* holds that just having different assets is not sufficient to avoid the doctrine, but it applies only to the extent of mutual value, *Estate of Cole v. Comm'r*, 140 F.2d 636 (8th Cir. 1944))
- One trust allows distributions without any standard but the other trust imposes a HEMS standard
- One trust might require considering the beneficiary-spouse's outside resources and the other would not
- One of the spouses would become a discretionary beneficiary only after the lapse of some specified time (say, 5 years) or on the occurrence of some event (for example, Letter Ruling 200426008 addresses trusts under which (i) husband would not become a beneficiary of wife's trust until three years after wife's death and then only if the husband's net worth did not exceed a specified amount and his income from personal services was less than a specified amount, and (ii) wife had a "5 or 5" withdrawal power from husband's trust after their son's death)
- One trust includes the donor's spouse as a discretionary beneficiary but the other trust would merely give an independent party (not exercisable as a fiduciary), perhaps after the passage of some specified time, the authority to add that donor's spouse as a discretionary beneficiary
- One trust allows conversion to a 5% unitrust but the other trust prohibits that
- Different termination dates and events
- Inter vivos power of appointment in one trust and not the other (like *Levy)*
- Different testamentary powers of appointment (maybe one trust has one and the other does not or perhaps there are different classes of permitted appointees or perhaps in one trust the power is exercisable only with the consent of a non-adverse party)
- Different trustees
- Different removal powers (one allows the grantor to remove and comply with Rev. Rul. 95-58 but the other puts removal powers in the hands of some third party).

There may be an advantage to making the primary beneficiary the Settlors' grandchildren, and including each other only as secondary beneficiaries.

In any event the differences need to be "real." Additionally, the structure of the trusts is only part of the equation, and probably not the most important part. How the trusts are *administered after they are created* may be the most critical factor. Clients may want to make gifts to the trusts and then immediately start flowing cash out of the trusts to each other the same as they did before the trusts were created. If that is done, the IRS would likely argue the existence of a pre-arranged plan that the income or other benefits would come right back to the grantor, even if only indirectly through the spouse.

Consider not having each of the spouses serve as trustee of the other's trust. Reciprocal dispositive powers may be sufficient to invoke the reciprocal trust doctrine if the trusts are sufficiently interrelated; reciprocal economic interests may not be required. *See Bischoff v. Commissioner*, 69 T.C. 32 (1977); *Exchange Bank & Trust v. United States*, 694 F.2d 1261 (Fed. Cir. 1982).

For a more complete discussion of the reciprocal trust doctrine, authorities holding that the reciprocal trust doctrine does not apply if there are substantial differences between trusts, authorities for applying the doctrine to reciprocal powers, and related creditor's rights issues see Item 5.l of the summary at

http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/12_2012_Estate%2520Planning%2520Current%2520Developments.html

Creditor's Rights Issue? A possible concern with "non-reciprocal" trusts by each of the spouses for each other is that they may not be respected for state law purposes with respect to claims of creditors against the settlors. *Cf. Security Trust Co. v. Sharp*, 77 A.2d 543 (Del. Ct. Ch. New Castle 1950)(case did not involve a creditor attack on a reciprocal trust, but suggested in dictum that reciprocal trusts would be subject to attack by creditors). The *Security Trust* case was over 60 years ago, and it is difficult to locate any reported case in which creditors have attacked a reciprocal trust under this theory.

State legislatures may address this issue. An Arizona statute provides protection from a reciprocal trust attack when spouses create trusts for each other. ARIZ. REV. STAT. §14-10505(E).

The possibility of creditors attacking reciprocal trusts should not be a problem if the trusts are created under the laws of states that have adopted "self-settled spendthrift trust" provisions (as discussed in the following paragraph).

If the donors' creditors can reach the trust assets, that would cause inclusion in the donors' estates for estate tax purposes under §2036 (and possibly under §2038).

17. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Discretionary Trusts in Self-Settled Trust States

a. *Self-Settled Trust States.* Self-settled trusts may be considered in jurisdictions that allow distributions to the settlor in the discretion of an independent trustee without subjecting the trust to claims of the settlor's creditors (and therefore estate inclusion). This will raise the issue of whether a client can create a trust, with the possibility of it serving as a "rainy day fund" in the unlikely event that financial calamities occur, without triggering §2036(a)(1) (a transfer with an implied agreement of retained enjoyment).

Thirteen states have adopted varying approaches regarding "self-settled spendthrift trusts": Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio (the most recent state to adopt a self-settled trust statute), Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming. (In addition, Oklahoma law provides that the a settlor's creditors cannot reach the assets of a revocable trust up to $1 million established for the settlor's spouse, descendants or charities, but this does not recognize "self-settled trusts" because the settlor cannot be a beneficiary of that trust.) Self-settled trusts, with the grantor as a discretionary beneficiary, can be used to overcome the concern of some clients that they will run out of money. Establish the trust in one of those states so that creditors do not have access to the trust.

b. *Section 2036 Concerns.* Creating the trust under the laws of a self-settled trust state can help alleviate concerns that §2036 may apply to the trust. Furthermore, the trust could be structured to include only the settlor's spouse as beneficiary as long as the settlor is married — so that the settlor is not even a direct beneficiary as long as he or she is married. The potential §2036 concern could be further ameliorated by giving someone the power to remove the settlor as a beneficiary, and that power could be exercised when the settlor is near death. Whether a retained enjoyment exists under §2036 is tested at the moment of death, and §2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary (as long as no prearrangement exists). *See* Tech. Adv. Memo. 199935003 (§2035 will apply if pre-planned arrangement).

A §2036 concern may arise if the settlor ever needs distributions from the trust and distributions are made to the settlor. That might give rise to at least an argument by the IRS of a pre-arrangement or implied agreement that distributions would be made when requested. Of course, if the settlor gets to the point of needing distributions from the trust, estate tax concerns may be the least of the settlor's worries.

Private Letter Ruling 200944002 addressed an Alaska trust and recognized that the "trustee's authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under §2036" as long as state laws provide that including the grantor as a discretionary beneficiary does not cause the trust to be subject to claims of the grantor's creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor "combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under §2036." Beginning in late 2011, the IRS has told other parties requesting similar rulings that it is not willing to issue further similar rulings. According to counsel, the Service's unwillingness to rule is not attributable to family exceptions or other differences under the laws of other states. Rather, the Service appears to be troubled by commentary about the *Mortensen* Alaska bankruptcy case. *Battley v. Mortensen,* Adv. D.Alaska, No. A09-90036-DMD (2011) allowed the bankruptcy trustee to recover assets transferred to an Alaska "self-settled trust" under the 10-year "clawback" provisions of §548(e) of the Bankruptcy Act. The agents at the Service said that PLR 200944002 probably wouldn't have been issued if they were looking at it now and that the Service since has declined other Alaska ruling requests.

PLR 200944002 is consistent with prior cases that have analyzed gross estate inclusion under §2036 in part based on whether trust assets can be reached by any of the grantor's creditors. For further discussion of those cases and §2036 issues surrounding the use of self-settled trusts, see Item 5.m of the summary at http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/12_2012_Estate%2520Planning%2520Current%2520Developments.html

c. *Potential Incomplete Gift Issue.* Some planners have expressed concern that the IRS might take the position that the gift is an incomplete gift, because of the possibility (perhaps, however remote) that creditors might be able to reach the assets. *E.g., Outwin v. Comm'r,* 76 T.C. 153, 162-65 (1981)(gift to trust incomplete if creditors can reach trust assets); *Herzog v. Comm'r*, 116 F.2d 591 (2d Cir. 1941)(gift to trust is completed gift if state law provides that settlor-beneficiary's creditors could not reach the trust corpus or income). The Illinois Supreme Court recently held that a decedent's creditors could reach assets that had been transferred to a Cook Islands trust. *Rush University Medical Center v. Sessions*, 2012 Ill. 112906 (2012). That case involved an egregious fact situation in which an individual transferred almost all of his assets to a Cook Islands trust of which the settlor was a discretionary beneficiary, knowing that he had made a large charitable pledge and that his remaining assets would not be sufficient for his estate to satisfy the pledge. The court did not address which jurisdiction's law should apply under relevant conflict of laws principles, but held that the state's passage of a fraudulent conveyance statute did not supersede Illinois common law principles allowing the creditors of a settlor to reach trust assets to the extent that the trust assets could be distributed to the settlor. In *Rush*

University, the Cook Islands trust owned real estate in Illinois that had sufficient value to satisfy the judgment, so apparently there was no issue about having to enforce the judgment in the Cook Islands. That case has caused concern among some planners about whether transfers to domestic asset protection trusts might arguably be incomplete gifts if the settlor resides and has assets in another jurisdiction that does not have "self-settled trust" legislation.

18. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Sale for Note or Annuity

A sale transaction is a "leaky" freeze, but may leave the client in a much more comfortable position than making gifts of $5 million (or $10 million for couples). For example, a client may make a smaller gift to a grantor trust, but make a sale of $10 million. The client continues to have access to principal and interest on the $10 million note, as compared to a $10 million outright gift where there is no retained benefit. A "leaky" freeze may not be perfect from an estate planning perspective, but the client may be much more comfortable. "Don't let the perfect get in the way of the good if the only way to get anything done is a leaky freeze."

If a client has long ago made transfers to a grantor trust, the client might consider selling substantial assets to the trust in return for a lifetime annuity. The annuity approach may be quite comforting to the client, to know that assts would continue to be paid to the client for his or her lifetime (to assure that the client would have funds for living expenses for life). An "old and cold" trust should be used to build the best arguing position that the transfer is made for full consideration so that §2036 should not apply. The trust would have to contain sufficient assets to satisfy the "exhaustion" test described in Reg. §§25.7520-3(b)(2)(i), 20.7520-3(b)(2)(i) and 1.7520-3(b)(2)(i), which assumes that the measuring life will live to age 110. If the trust does not have sufficient assets to cover all of the exhaustion test, it may be possible for individuals to guarantee the annuity to avoid the impact of the exhaustion test.

19. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Transfer of Residence to Trust or Co-Tenancies Between Grantor/Spouse of Grantor and Trust

Clients often prefer gifting residences or vacation homes to a trust rather than gifting cash and securities. If all of the residence is transferred to the trust, the grantor should be able to avoid inclusion in the grantor's estate under §2036 even if the grantor uses the residence, as long as the grantor pays fair market rent for any use of the residence.

a. *Payment of Fair Market Rent.* Applying §2036 if the grantor pays a fair rent is problematic, because the statute only applies to transfers for less than full and adequate consideration, and the donor would be paying full consideration for the right to use the property. It is ironic that paying rental payments would even further deplete the donor's estate. However, the trend of the cases is not to apply §2036 where adequate rental is paid for the use of the property. *E.g., Estate of Barlow v. Comm'r*, 55 T.C. 666 (1971) (no inclusion under §2036 even though decedent stopped paying rent after two years because of medical problems); *Estate of Giselman v. Comm'r*, T.C. Memo 1988-391. The IRS has ruled privately in several different rulings that the donor of a qualified personal residence trust may retain the right in the initial transfer to lease the property for fair rental value at the end of the QPRT term without causing estate inclusion following the end of the QPRT term under Section 2036. *E.g.*, Ltr. Rul. 199931028. However, the IRS does not concede that renting property for a fair rental value always avoids application of Section 2036. *See* Tech. Adv. Memo. 9146002 (*Barlow* distinguished). Most of the cases that have ruled in favor of the IRS have involved situations where the rental that was paid was not adequate. *E.g., Disbrow v. Comm'r*, T.C. Memo 2006-34 (court also concluded that the annual lease agreements were a subterfuge to disguise the testamentary nature of the transfer for various reasons); *Estate of Du Pont v. Comm'r*, 63 T.C. 746 (1975).

For a more complete discussion of the effect of paying fair market rent, see Item 17.b(4) of the 2012 Heckerling Musings at http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/01_2012_Heckerling%2520Summary.html

b. *Grantor Trust to Avoid Rental Income Recognition*. If the donor pays rent to a grantor trust, there is no recognition of rental income because the donor is treated as paying rent to herself. However, rent paid to a spouse or to a trust treated as owned by the renter's spouse under the grantor trust rules is taxable income (because §1041 merely provides that there is no income recognition for "transfers" between spouses). *See Gibbs v. Comm'r*, T.C. Memo 1997-196 (recognition of interest income on payment of interest from the grantor's spouse).

c. *Co-Tenancy to Avoid Paying Rent (or Reduce Rent)*. Although paying rent further depletes the value of the donor's estate for estate tax purposes, the idea of paying rent to the trust is not appealing to some clients, although fair market rent may not be much more than the ownership costs shifted to the trust for paying real estate taxes, insurance, and major maintenance costs. If a fractional interest is given to the trust, with the donor retaining a fractional interest, the donor would not have to pay rent with respect to the retained interest. Where only a fractional interest in a property is transferred, the donor may retain proportionate use of the property consistent with the retained ownership. *Estate of Wineman v. Comm'r*, T.C. Memo. 2000-193 (2000).

To go a step further—co-tenants are each entitled to nonexclusive possession rights, so can the donor continue to live in the residence because of his or her retained undivided co-tenancy interest without paying rent as long as the donor does not want exclusive possession of the residence? *Stewart v. Comm'r*, 617 F.3d 148 (2d Cir. 2010) involved a situation in which a mother and son both co-occupied a residence. The mother transferred a 49% undivided interest in the residence to the son and they both continued living there. The court (over a strong dissent) stated that "co-occupancy of residential premises by the related donor and donee is highly probative of the absence of an implied agreement." The court suggested a test for residential premises, providing that if there is both "continued exclusive possession by the donor and the withholding of possession from the donee," §2036(a)(1) will apply. The court suggested strongly that §2036(a)(1) would not apply if there is continued occupancy by both owners.

Use a tenancy in common rather than joint tenants with right of survivorship (because §2040 causes estate inclusion for the donor except to the extent that the transferee pays consideration).

For a more complete discussion of the effect of co-tenancies and the ability to continue to use a residence as a co-tenant without invoking §2036 see Item 17.b of the 2012 Heckerling Musings at

http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/01_2012_Heckerling%2520Summary.html

20. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Exercise Swap Power or Repurchase Assets From Trust

A donor may choose to purchase assets from grantor trusts in return for long-term low-interest notes if the donor would like to re-acquire those assets (to be able to enjoy the income produced by those assets or to be able to achieve a basis step up at the donor's subsequent death). **That approach will not eliminate the gift but it might reduce the value remaining in the trust. *See generally* Clay Stevens, *The Reverse Defective Grantor Trust,* TR. & ESTS. 33 (Oct. 2012**). The principles that apply to sales to grantor trusts should apply to the repurchase transaction, except that the grantor may prefer to use a higher interest rate than the AFR. While the transfers may be disregarded for federal income tax purposes, they may still be subject to local transfer and recording taxes (for real estate sales) or sales taxes (for example, for art sales).

21. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Preferred Partnership Freeze

Ellen Harrison summarizes that a donor may create a partnership and retain the right to a preferred return and give to an irrevocable trust the common interest that has the right to excess return and appreciation. Only the preferred interest is included in the estate (plus cumulative payments on the preferred interest that have not been consumed).

Unless the preferred interest satisfies the rules of §2701, the value of the gift of the common interest is determined by treating the preferred interest as having zero value. *See* §2701(a)(3)(A). However, the mitigation rule in Reg. §25.2701-5(a)(3) makes the zero value rule less significant. Reg. §2701-5(a)(3) provides for an "adjustment to mitigate double taxation." The amount on which the estate tax is calculated is reduced by an amount equal to the amount by which the taxable gift was increased under §2701. The effect is that the client has kept the preferred stock, and may have enjoyed the distributions from that stock over the client's lifetime, but the client still gets to subtract from the estate tax base the substantial amount by which the gift was increased under §2701.

22. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Terminate Grantor Trust Status

This strategy does not actually benefit the grantor or grantor's spouse but is a way of reducing the financial pain to the grantor or grantor's spouse resulting from the existence of the trust. The donor may be able to take steps to terminate the grantor trust status of the trust so that it pays its own income tax going forward. However, that may reduce planning flexibilities in the future (i.e., swaps or sales would be taxable events) because the trust is no longer a grantor trust.

Turning off grantor trust status could be accomplished by giving a protector the power to amend the trust to eliminate the grantor trust trigger provision. If the grantor's spouse is a beneficiary of the trust, this will require terminating the spouse's interest. The protector's power should be exercisable in a non-fiduciary capacity and there should be strong exculpation provisions because it is hard (although not impossible) to see how the exercise of the power could benefit the beneficiaries.

If the sole trust trigger is a retained non-fiduciary power of substitution by the grantor, the grantor probably cannot be prevented from renouncing the power, which gives the grantor the ability to turn off grantor trust status.

23. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Payment of Management Fees to Grantor

Grantors may retain control over investment decisions without triggering §2036 as long as the grantor does not indirectly control beneficial enjoyment or have the right to vote the stock of a closely held corporation. The investment power should be subject to the right of the trustee to require that cash be provided to fund distributions that are appropriate under the trust distribution standards. The grantor could be named as investment manager or could be the manager of an LLC owned by the trust. The grantor could, but is not obligated to, take a management fee for the services rendered. *See Estate of Kelly v. Comm'r*, T.C. Memo. 2012-73 (payment of management fee to corporation owned by decedent for serving as general partner of limited partnership did not trigger §2036 because the general partner's fiduciary duty and contractual terms of the partnership restricted the decedent from acquiring the partnership to pay more than a reasonable fee to the general partner, the management fee was reasonable and in fact was lower than the industry standard, and the decedent had a bona fide purpose for creating the corporation to manage the partnership).

24. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Inter Vivos QTIPable Trust

A spouse could make a gift to a "QTIPable" trust for the other spouse. Advantages of this planning approach include the following:

a. *Defer Taxable Gift Decision*. The grantor can defer the decision of whether to treat the transfer as a taxable gift utilizing the grantor's lifetime gift exemption amount (or requiring the payment of current gift taxes) until the grantor's gift tax return is filed (possibly until October 15 of the following calendar year). If the grantor decides that it would be best not to make a taxable gift, the grantor would make a QTIP election so that the transfer qualifies for the gift tax marital deduction (in which event the trust assets will be included in the donee-spouse's estate for estate tax purposes). If the grantor decides to treat the transfer as a taxable gift (using up gift exemption or requiring the payment of gift tax), the QTIP election would not be made. For example, if the assets decline in value substantially the grantor may decide not to treat the transfer as a taxable gift using up gift exemption based on the higher date of gift value.

b. *Formula QTIP Election as Defined Value Approach*. Though untested by cases but apparently allowed by regulations, a formula QTIP election may allow the grantor to limit gift tax exposure to a desired specified amount. In effect, this would have the same advantages of defined value clauses, and would be based on provisions in regulations allowing formula QTIP elections. See Treas. Reg. §§20.2056(b)-7(b)(2)(i) & 20.2056(b)-7(h) Exs. (7-8). For a discussion of the mechanics of making a formula election, see Tech. Adv. Memo. 9116003 (discussing validity of QTIP election of "an amount from the assets ... equal to the minimum amount necessary to reduce the federal estate tax payable as a result of my death to least amount possible ...").

c. *GST Exemption Allocation*. There is flexibility to allocate the grantor's GST exemption (by making a "reverse QTIP" election under §2652(a)(3)), to allocate the spouse's GST exemption, or not to allocate any GST exemption to the trust. This decision can be deferred until when the gift tax return is due (possibly until October 15 of the following year).

d. *No Clayton QTIP For Inter Vivos QTIPs*. The "Clayton regulation" provides that for testamentary transfers, the instrument can provide that the portion of the assets for which the QTIP election is not made may pass to a trust having different terms than the required terms for a QTIP trust — including a trust that would be similar to a standard "bypass trust" for the spouse and descendants and that would not be in the spouse's estate for estate tax purposes. However, there is no similar regulation that clearly applies for gift tax purposes for inter vivos transfers. The Clayton provision in Treas. Reg. §20.2056(b)-7(d)(3) appears only in the estate tax regulation — it is not also in the similar gift tax regulation, Reg. §25.2523(f)-1(b). Indeed, if a Clayton provision added other beneficiaries if the QTIP election is not made, it would seem that the gift would not be complete in the year of the original transfer — because the donor would retain the power to shift benefits among beneficiaries until the gift tax return filing date has passed. (Conceivably the gift would never become complete during the donor's lifetime because the return making the election would always be due the following year, thus extending the completion of the gift to the following year, extending the due date of the return to the year after that, etc.)

25. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Retained Income Gift Trust

The "Retained Income Gift Trust" (RIGT) is an idea that has been suggested for making a completed gift, retaining the right to the income from the trust, and shifting future appreciation so that it is excluded from the grantor's gross estate. The income itself would be distributed back to the donor resulting in a "leaky" freeze, but if the assets are invested for capital appreciation the income might be relatively small.

Advantages. If the strategy works as intended, when the grantor dies, the grantor would not be treated as having used up any of his or her estate tax exemption amount and there would be a stepped up basis for the trust assets. Furthermore, any gift taxes paid more than three years before the grantor's death would also be removed from the estate. The plan has been suggested by Igor Potym (with VedderPrice P.C. in Chicago, Illinois) and was discussed by Richard Covey in the mid-1990s. Igor describes the plan:

> There is another type of irrevocable trust where the grantor is a beneficiary, a retained income gift trust (RIGT), that seems attractive now. Donor makes a gift and retains an income interest (but not a principal interest) for life.The trust is a completed gift and the retained income interest does not reduce the gift because it is not a qualified interest under section 2702. This looks a lot like a pre-chapter 14 GRIT, except it lasts for life and we now have section 2702.
>
> The trustee is given discretion to distribute principal to descendants at any time and typically will strip off appreciation, keeping the trust at its original gift value. When the grantor dies, the trust is included in his gross estate. Because it is included, the gift is not treated as an adjusted taxable gift and therefore no unified credit is wasted. The assets get a stepped-up basis.
>
> The principal that was distributed to descendants during the grantor's life is not included in the gross estate and is not an additional gift because the gift was complete on day one. In effect, this is a freeze with respect to appreciation in excess of the gift, whether the gift is $5,120,000 or greater. Also, if gift tax is paid, the tax is excluded from the gross estate unless the three-year rule applies, but in such case all the assets of the trust get a stepped-up basis.
>
> This trust can be used to deal with the claw back under section 2001(b), at least in part (upon death, it can qualify for the marital deduction).
>
> In the mid 1990s, I ran this by Dick Covey and, with our permission, he mentioned it briefly in Practical Drafting (April 1997, at 4788-4789) and talked about it in Miami. He was convinced it worked. In fact, it has withstood audit every time. No

agent has ever seriously questioned it, perhaps because the agents think it was a drafting mistake. I believe the technique works, possibly better than ever.

Think about the client who can't afford to make a $5,120,000 gift because he needs the income, but would love to shift future appreciation on this amount without incurring an estate tax at the death of the first spouse due to the claw back. Or, possibly even better, a client who makes a gift and pays gift tax. The gift tax is out of the estate, the grantor keeps the income from principal remaining in the trust, the trust gets a stepped-up basis, there is no adjusted taxable gift at death because the trust is included in the gross estate, the estate tax on the trust is reduced by the gift tax paid dollar for dollar (in other words, inclusion in the gross estate does not generate any additional estate tax) and stripped off appreciation avoids estate tax.

Some commentators have suggested that the IRS might question whether the gift to the trust would properly be excluded from the estate tax calculation as an adjusted taxable gift under §2001(b) because the gift assets are included in the estate under §2036, in light of the fact that all appreciation of the gift assets are not being included in the gross estate.

26. Wealth Transfer Strategies — Generally

There are a wide variety of additional wealth transfer strategies in addition to the strategies addressed above that may benefit the grantor and/or grantor's spouse. Some of these may be particularly appropriate if the grantor has already used all of his or her gift exemption amount.

These strategies include:

- Defined value formula transfers;
- GRAT strategies;
- Remainder purchase marital trusts;
- Installment sales to grantor trusts or to spousal grantor trusts;
- Installment sales by beneficiary to section 678 trusts or to QSSTs; and
- Any of these strategies may involve family limited partnerships, LLCs or other family entities.

Each of these is discussed in Items 27-33 below.

27. Defined Value Clause Updates, Including *Wandry*

a. *General Description of Defined Value Clauses and "Formula Transfer" vs. "Formula Allocation" Approaches*. In making transfers of hard-to-value interests, such as limited partnership interests in an FLP, some planners have structured gifts or sales of a specified dollar amount of limited partnership interests. One attorney has analogized this to going to a gas station and asking for $10 worth of gasoline. While that seems straightforward enough (and is strikingly similar to marital deduction formula clauses that are commonly accepted in testamentary instruments), the IRS objects, largely on the grounds that the clause would make IRS gift tax audits meaningless.

There are two general types of traditional defined value clauses, "formula transfer clauses" and "formula allocation clauses."

(1) *Formula Transfer Clause*. A "formula transfer clause" limits the amount transferred (i.e., transfer of a fractional portion of an asset, with the fraction described by a formula). An example of a *very simple* fractional formula transfer clause, which the IRS approved back in 1986 in Technical Advice Memorandum 8611004 (but would no longer approve), is as follows:

> such interest in x partnership…as has a fair market value of $________.

Another example, somewhat more complicated but still simple in concept (designed to produce a small gift if the IRS asserts higher values for gift tax purposes to help counter a *Procter* "mootness" attack) is as follows:

> I hereby transfer to the trustees of the T Trust a fractional share of the property described on Schedule A. The numerator of the fraction is (a) $100,000 [i.e., the desired dollar value to be transferred by gift] plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the 'Gift Tax Value') over $100,000. The denominator of the fraction is the Gift Tax Value of the property.

McCaffrey, *Tax Tuning The Estate Plan By Formula*, 33rd ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING ¶ 402.4 (1999).

(2) *Formula Allocation Clause*. A "formula allocation clause" allocates the amount transferred among transferees (i.e., transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees includes charities, spouses, QTIP trusts, "incomplete gift trusts" (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and "zeroed-out" GRATs. With this second type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values. For example, the *McCord* and *Hendrix* cases used the second type of clause with the allocation being based on a "confirmation agreement" among the transferees. The two other cases addressing formula allocation clauses have both involved clauses that were based on finally determined estate (*Christiansen*) or gift (*Petter*) tax values.

The formula allocation clause is significantly more complicated and by its nature includes multiple parties other than just the donor and donees. In all of the reported cases so far, these types of cases have involved a charity to receive the "excess value" over the stated dollar amount passing to family members.

b. *Four Cases Have Approved Formula Allocation Clauses With "Excess" Value Passing to Charity*. Four cases have previously recognized formula allocation defined value clauses *McCord v. Commissioner,* 461 F.3d 614 (5th Cir. 2006); *Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009), *Petter v. Commissioner,* T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011), and *Hendrix v. Commissioner*, T.C. Memo. 2011-133).

As mentioned above, those cases have taken different valuation approaches in the formula allocation. Two of the cases relied on an agreement among the transferees as to valuation (*McCord* and *Hendrix)* and the other two cases on finally determined estate (*Christiansen*) or gift (*Petter*) tax values.

c. *Court Approval of Formula Transfer Approach: Wandry v. Commissioner.*

Synopsis

In *Wandry v. Commissioner* T.C. Memo 2012-88, the court upheld a stated dollar value "formula transfer" clause of, in effect, "that number of units equal in value to $x as determined for federal gift tax purposes." This is a very important development in the structuring of defined value transfers. This case literally opens up the simplicity of giving "$13,000 worth of LLC units" to make sure the gift does not exceed a desired monetary amount, or giving "$5,000,000 worth of LLC units" to make sure the donor does not have to pay gift tax as a result of the transfer of a hard-to-value asset. For sure, the planner would use a little more verbiage than that, but the simplicity of that kind of transfer is what the court recognized in *Wandry*. This is a much simpler approach than the formula allocation approach involving charities that has been approved in four earlier cases. While this kind of transfer seems straightforward enough (and is strikingly similar to marital deduction formula clauses that are commonly accepted in testamentary instruments), the IRS objects, largely on the grounds that the clause would make IRS gift tax audits meaningless. The court rejects those arguments in *Wandry*.

Parents made gift assignments of "a sufficient number of my Units as a Member of [an LLC], so that the fair market value of such Units for federal gift tax purposes shall be as follows: [stated dollar values were listed for various donees]." Following the list of dollar values was a general statement making clear that the donor intended to have a good-faith determination of such value by an independent third party professional, but if "the IRS challenges such valuation . . . , the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

The court, in an opinion by Judge Haines, held that the parents made gifts of a specified dollar value of membership units rather than fixed percentage interests in the LLC. The gift tax returns and the attached schedules reported gifts of those dollar amounts. Unfortunately, the descriptions of the gift assets on the return created some confusion by referencing specific percentage interests, rather than clearly describing the gifts as a particular dollar amount worth of units, but Judge Haines concluded that the parties clearly intended to make dollar value gifts and the schedules of the gift tax returns indeed reported the gifts as gifts of specific dollar values. The court also rejected an argument by the IRS that the capital accounts control the nature of the gifts and that the capital accounts reflect gifts of fixed percentage interests. To the contrary, the court determined that the underlying facts determine capital accounts, not the other way around. Book entries do not override more persuasive evidence that points to the contrary. (A further problem with the structure of the transaction, which interestingly was not criticized by the court, was that the donor waited 19 months to obtain an appraisal to know the number of units that were transferred under the formula assignment.)

Finally, the court addressed the IRS's argument that the formula assignment was an invalid "savings clause" under the old *Procter* case. Judge Haines concluded that the transfers of Units having a specified fair market value for federal gift tax purposes are not void as savings clauses — they do not operate to "take property back" as a condition subsequent, and they do not violate public policy.

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

As discussed below, this case is not being appealed by the IRS, but the IRS has filed a nonacquiescence in the case.

Basic Facts

All of the facts were stipulated by agreement of the IRS and the donors. Parents made gifts of limited partnership interests beginning January 1, 2000, as advised by their tax attorney, of specific dollar amounts rather than a set number of units. (Apparently, the IRS did not raise any issues about the gifts of the limited partnership interests and they were not involved in this case.) The partnership assets were later contributed to an LLC, which also housed a family business. Parents continued their gift giving program of LLC units in a similar fashion. Because the number of membership units equal to the desired value of their gifts on any given date could not be known until a later date when a valuation could be made of the LLC's assets, the attorney advised that "all gifts should be given as specific dollar amounts, rather than specific numbers of membership units."

On January 1, 2004, each of the parents wished to give LLC units equal to their $1,000,000 gift exemption amounts equally among their four children and their $11,000 annual exclusion amounts to each of their four children and five grandchildren. Pursuant to their attorney's advice they made gifts of LLC units "*so that the fair market value of such Units for federal gift tax purposes*" equaled those desired dollar amounts.

The actual assignment documents that each of the parents used is as follows [the actual full assignment document is quoted because it may serve as a helpful form for defined transfer assignments by planners in the future]:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000

Name	Gift Amount
Grandchild E	11,000
	1,099,000

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

The donors and family members' understanding of the nature of the gifts is summarized by the court (and stipulated by all parties) as follows--

> The only gifts with respect to Norseman membership units that petitioners ever intended to give were of dollar amounts equal to their Federal gift tax exclusions. At all times petitioners understood and believed that the gifts were of a dollar value, not a specified number of membership units. Petitioners' tax attorney advised them that if a subsequent determination revalued membership units granted, no membership units would be returned to them. Rather, accounting entries to Norseman's capital accounts would reallocate each member's membership units to conform to the actual gifts.

An independent appraiser valued the LLC assets as of January 1, 2004 in its report issued July 26, 2005, finding that a 1% Norseman interest was worth $109,000. Based on that value, the CPA entered on an undated and handwritten ledger that adjustments were made to the capital accounts in 2004, decreasing the parents' combined capital accounts by $3,603,311 attributable to the gifts, resulting in increases to capital accounts to each of the children and grandchildren of approximately $855,745 and $36,066, respectively.

The CPA prepared gift tax returns for the parents. Consistent with the gift documents, each of the parent's returns reported total gifts of $1,099,000 and attached schedules reporting net transfers of $261,000 to each of the four children and $11,000 to each of the five grandchildren. However, the schedules "describe the gifts to petitioners' children and grandchildren as 2.39% and .101% Norseman membership interests, respectively (gift descriptions). Petitioners' C.P.A. derived the gift descriptions from the dollar values of the gifts listed in the gift documents and the gift tax returns and the $109,000 value of a 1% Norseman membership interest as determined by the K&W report." [In retrospect, the gift descriptions should have been more detailed, reflecting them as dollar value gifts.]

The IRS audited the gift tax returns. The parties ultimately agreed upon $132,134 as the value of a 1% interest in the LLC, and the IRS took the position that the gifts were of the percentage amounts listed in the "gift descriptions" and that multiplying those percentage amounts times the stipulated value of a 1% interest resulted in a gift tax deficiency.

Holdings

(1) The parents made gifts of a specified dollar value of membership units rather than fixed percentage interests in the LLC.

(2) The transfers of Units having a specified fair market value for federal gift tax purposes are not void as savings clauses because they do not operate to "take property back" as a condition subsequent, and do not violate public policy. As to the public policy issue, the court quoted the Supreme Court's conclusion that public policy exception to the Code should be recognized only for "severe and immediate" frustrations, and analyzed why the three public policy issues raised in the *Procter* case do not apply. The court in particular concluded that the lack of a charitable component in these transfers does not result in a "severe and immediate" public policy concern.

Analysis of "Procter" Issue

(1) *Assignments Are Not Void as Savings Clauses Because They Do Not Operate to "Take Property Back" Upon a Condition Subsequent.* The IRS argued that the assignments were an improper use of a formula to transfer assets in violation of principles established in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). In *Procter*, the trust indenture making the gift included the following clause:

> Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property *hereby transferred* which is decreed by such court to be subject to gift tax, shall automatically be *deemed* not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created. (Emphasis added)

[Observation: The literal language of the transfer document in *Procter* contemplates that there is a present transfer that counsel believes is not subject to gift tax, and that any property "*hereby transferred*" that would be subject to gift tax is "*deemed*" not to be included in the conveyance. This is different from the clause in Wandry that only purported to transfer a specified dollar value of property and nothing else.]

The court in *Wandry* summarized that the "Court of Appeals for the Fourth Circuit held that the clause at issue operated to reverse a completed transfer in excess of the gift tax . . . [and] was therefore invalid as a condition subsequent to the donor's gift." (The court also summarized *Proctor's* public policy analysis; that is discussed below.)

The court reviewed other cases that have rejected attempts to reverse completed gifts in excess of gift tax exclusions. (*Ward v. Commissioner*, 87 T.C. 78 (1986); *Harwood v. Commissioner,* 82 T.C. 239 (1984), *aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986).) The court reviewed other cases that have recognized valid formulas to limit the value of a completed transfer. (*Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009)(defined value disclaimer so that assets in excess of defined value passed to charities); *Estate of Petter v. Commissioner,* T.C. Memo. 2009-280, *aff'd* 653 F.3d 1012 (9th Cir. 2011); *McCord* *v. Commissioner,* 461 F.3d 614 (5th Cir. 2006), *rev'g,* 120 T.C. 358 (2003).) (Interestingly, the court did not cite *Hendrix v. Commissioner,* T.C. Memo. 2011-133 (June 15, 2011), which also upheld a defined value sale/gift transfer.) The court noted that *King v. United States*, 545 F.2d 700 (10th Cir. 1976) upheld a formula that adjusted the purchase price of shares sold to a trust for children if the IRS determined the fair market value of the shares to be different than the sale price, but the court viewed that as an adjustment to the consideration paid in the sale rather than an adjustment of the shares transferred, and therefore not controlling in this case.

To determine what types of clauses are valid and which ones are not, the court focused on the analysis in *Estate of Petter,* which drew a distinction between a "savings clause," which is not valid, and a "formula clause," which is valid.

> A savings clause is void because it creates a donor that tries 'to take property back.' [citing *Petter*]. On the other hand, a 'formula clause' is valid because it merely transfers a 'fixed set of rights with uncertain value.' [citing *Petter*]. The difference depends on an understanding of just what the donor is trying to give away. [citing *Petter*].

The court applied various analytical steps (quoted below in italics) that the 9th Circuit isolated in its description of the operation of the formula in *Petter.*

- "Under the terms of the transfer documents, the foundations were always entitled to receive a predefined number of units, which the documents essentially expressed as a mathematical formula." In Wandry, the units that the donees were entitled to receive essentially were expressed as a mathematical formula. Each of the children was entitled to receive a percentage of units equal to $261,000/FMV of Norseman. Each of the grandchildren was entitled to receive a percentage of units equal to $11,000/FMV of Norseman.
- "This formula had one unknown: the value of a LLC unit at the time the transfer documents were executed. But though unknown, that value was a constant." Similarly in Wandry, the formula had one unknown, the value of Norseman. "But though unknown, that value was a constant." The parties stipulated that the value of Norseman was $13,213,389. "This value was a constant at all times."
- "Before and after the IRS audit, the foundations were entitled to receive the same number of units." Before and after the audit in Wandry, the children were each entitled to receive a 1.98% interest ($261,000/$13,213,389) and the grandchildren were each entitled to receive a 0.83% interest ($11,000/$13,213,389).
- "Absent the audit, the foundations may never have received all the units they were entitled to, but that does not mean that part of the Taxpayer's transfer was dependent upon an IRS audit. Rather, the audit merely ensured the foundations would receive those units they were always entitled to receive." On the facts of Wandry, the donees might never have received the proper percentage interests they were entitled to without an audit but that does not mean the transfers were dependent on an IRS audit. The audit just ensured they received the percentage interests they were always entitled to receive.

Summary of "Take Back"/Condition Subsequent Issue:

> It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization

> because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to 'take property back'. Rather, the gift documents correct the allocation of Norseman membership units among petitioners and the donees because the K&W report understated Norseman's value. The clauses at issue are valid formula clauses.

(2) *Formula Dollar Value Gift Assignments Do Not Violate Public Policy.* The court in *Wandry* summarized the *Procter* public policy argument as follows:

> The Court of Appeals further held that the clause was contrary to public policy because: (1) any attempt to collect the tax would defeat the gift, thereby discouraging efforts to collect the tax; (2) the court would be required to pass judgment upon a moot case; and (3) the clause would reduce the court's judgment to a declaratory judgment.

The court observed the Supreme Court's warning against invoking public policy exceptions to the Internal Revenue Code too freely, holding that the frustration caused must be "severe and immediate." *Commissioner v. Tellier,* 383 U.S. 687, 694 (1966).

As to *Procter's* first public policy reason, the court replied that the Commissioner's role is to enforce the tax laws, not just maximize tax receipts. Also there are mechanisms outside of IRS audits to ensure accurate valuation reporting. (In this case, the parties all had competing interests and each member of the LLC has an interest in ensuring that he or she is allocated a fair share of profits and not allocated any excess losses.)

As to *Procter's* second and third policy reasons, a judgment in these gift tax cases will reallocate units among the donors and donees. Therefore, the court is not ruling on a moot case or issuing merely a declaratory judgment.

The court very specifically addressed the fact that a charity was not involved in this case, but charities had been involved in the prior defined value cases approved by the courts as not violating public policy:

> In *Estate of Petter* we cited Congress' overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, ***but it was not determinative***. The lack of charitable component in the cases at hand does not result in a 'severe and immediate' public policy concern. (Emphasis added.)

Dropped Appeal and Nonacquiescence

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

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

d. *Planning With Defined Value Clauses (Particularly in Light of Wandry).*

(1) *Defined Value Clause Not Needed if Gift is Significantly Less Than Remaining Gift Exemption Amount.* An approach that many planners and clients use is to make a gift of significantly less than the remaining $5 million indexed gift exemption amount. If enough cushion is left, there may not be concerns of having to pay gift tax, even if the valuation is not exactly correct.

(2) *Formula Transfer Based on Appraisal Is Allowed.* As a practical matter, it is impossible to value a hard-to-value asset on the date of the transfer. A formula transfer of a dollar value worth of a particular asset, based upon an appraisal to be acquired within a specified term in the near future is routinely used, and is not viewed by the IRS as abusive. By the time the gift tax return is filed, the appraisal will be at hand, and a specific number of shares that have been transferred pursuant to the formula will be known and listed on the gift tax return. Obviously, that approach provides no protection against gift taxes in the event of an audit. The key distinction of the *Wandry*-type transfer is that the formula dollar value being transferred is based upon values as finally determined for federal gift tax purposes.

(3) *General Comfort With Formula Allocation Clauses (at Least With Charities).* Planners have a general level of comfort that defined value clauses using the formula allocation approach will be respected, at least where the excess value passes to charity. Three different circuit courts as well as the Tax Court have approved the formula allocation defined value approach (with the excess value passing the charity in all four cases).

If a client is not willing to involve charity, a formula allocation approach could be used with the excess passing to other alternatives, such as the donor's spouse, a marital trust (some planners prefer a general power of appointment trust rather than a QTIP trust because contingent QTIP elections are not allowed for inter vivos transfers, but if the transaction is structured so that some amount is designed to pass to the marital trust from the outset, a QTIP election would be allowed), an incomplete gift trust, or a zeroed-out GRAT. (A particular concern with using a zeroed-out GRAT is that the present value of the excess value would be transferred back entirely to the donor; that may represent a "taking back" concern under *Procter,* and perhaps a concern could be raised about the GRAT not being funded for the intervening months [or years] before the value is determined and about the failure to make required annuity payments during that time frame.)

That all involves more complexity than a straight gift or sale, or a straight gift or sale of "that number of units equal to $X." Many planners and clients have struggled with whether to make transfer under *Wandry*-type clauses when the clients are not willing to make transfers using formula allocations.

(4) *Position of Those Planners Who Are Uncomfortable With Wandry-Type Transfers.*

- *Wandry* is just a Tax Court memorandum decision by one judge (Judge Haines). (Query, why was that? Generally, Tax Court memorandum cases are those where the law is clear and the judge is just applying to law to the facts of the case. This is the first court to address a defined value formula transfer clause. Did the government lawyer not make very clear that this is a case of first impression? Did the Tax Court judges not understand that?)
- Some respected commentators view the *Wandry* opinion as poorly reasoned. (Other respected commentators have found the analysis persuasive and well reasoned.) If *Procter* is still good law, no doubt there are fine semantic lines being drawn between describing what is transferred vs. providing that something returns to the donor if the initial values are incorrect. The assignment in *Procter* is certainly similar in broad effect to the assignment in *Wandry* (though there is language in the *Procter* clause suggesting that the "excess property" was originally transferred but that it is "deemed" not to be in the conveyance).
- One commentator's criticism of the *Wandry* analysis focuses on the opinion's reference in several places to "allocations" and suggests that the opinion failed to recognize the key distinction between of reallocation of units among other takers vs. a reallocation of units back to the donor (suggesting that "allocation" to the donors looks more like retention, if not "taking back"), and suggesting that the "allocation" analysis fails to focus on the key distinction between an allocation of transferred units vs. a formula that describes the total amount transferred:

  > It is inconsequential that the adjustment clause *reallocates* membership units among petitioners and the donees rather than a charitable organization because the *reallocations* do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to "take property back". Rather, the gift documents correct the *allocation* of Norseman membership units among petitioners and the donees because the appraisal report understated Norseman's value. The clauses at issue are valid formula clauses. (Emphasis added).

- Another poorly reasoned statement in the opinion is the court's statement that other enforcement mechanisms than just IRS audits exist to ensure accurate valuation reporting. That does not make sense in the context of a transaction that is just between a donor and donee, both of whom may wish to have as many "units" transferred as possible without the imposition of gift taxes.
- The IRS position is that *Wandry* just can't be right because "we will always lose." What is the point of auditing these cases? The taxpayers will just correct the number of units in retrospect. (One commentator's reaction to this position is that Judge Haines shakes his finger at the IRS and says its job is to enforce the tax laws as written and not just to collect more revenues.)
- The IRS has filed a nonacquiescence.

- Planners practicing in the Fourth Circuit (i.e., Maryland, North Carolina, South Carolina, Virginia, and West Virginia) are particularly wary about using *Wandry* clauses. The *Procter* case is a Fourth Circuit case, and "the Fourth Circuit never met a tax it didn't like."
- Many of the planners who are unwilling to rely on *Wandry* nevertheless think it is properly decided.
- Potential disadvantages are: (i) red flag issue for IRS auditors, (ii) a gift tax return must be filed because valuation will be based upon values as finally determined for gift tax purposes, (iii) that the clause arguably might cause the gift to be incomplete (because the donor will make decisions in the gift tax audit about settlement or pursuing the case to litigation), (iv) the potential whipsaw effect if the courts do not respect the clause but it is still binding for state law purposes, and (v) if the gift asset explodes in value after the transfer, the donor may prefer to pay gift tax on the relatively small value at the time of the gift to keep the huge appreciation from the units that remain with the donor under the *Wandry* clause out of the donor's estate. See subparagraph (6) below for further discussion of the disadvantages.

(5) *Position of Those Planners Who Are Comfortable With Wandry-Type Transfers.*

- Even planners more comfortable with the *Wandry* approach are reluctant to rely on *Wandry* if the client is making the transfer primarily in reliance upon protection against having to pay gift taxes because of *Wandry*. However, if the client is planning to make the transfer in any event and will get good appraisals in any event, many planners are using the *Wandry* formula approach to provide an additional argument in case of a gift tax audit.
- Although this is just a Tax Court memorandum case, these planners find the reasoning of the case persuasive. Even though some of the reasoning could be better (see the discussion above), the gist of the opinion focused on the fact that the assignment just describes what is transferred, albeit using a formula. The opinion applies reasoning of the 9th Circuit in *Petter*.
- *Wandry* reached a favorable result in spite of some terrible facts: (i) the gift tax return had an attachment that in one place inartfully referred to a particular percentage interest that was transferred rather than a dollar value, (ii) the donor waited 19 months to get an appraisal to know how many units of the LLC were transferred (which may have suggested that the parties were not really serious about the transfer being just a dollar value of units), and (iii) adjustments in capital accounts did not reflect reality in light of the formula clause.
- *Procter* can be distinguished. Much of the attention in *Procter* was that the clause would change what had previously been transferred automatically based on what the court decreed and that the clause was undoing whatever the court decided. The focus was not that an adjustment was made after the transfer, but that the adjustment occurred after the court decree had already determined that a gift tax was due. Furthermore, some planners believe that even the Fourth Circuit would not decide *Procter* the same as it did 60 years ago because (i) formula clauses have become very routinely used in the

meantime (marital deduction formula clauses, charitable remainder trusts, GRATs, disclaimers, GST allocations, etc.), and (ii) the U.S. Supreme Court in the meantime has ruled that public policy concerns should override traditional tax principles only if the policy frustrations are "severe and immediate" (*Tellier)* and some of the formula allocation cases have referred to that Supreme Court pronouncement in finding that the clause did not rise to the level of a "severe and immediate" frustration of public policy.

- Formula clauses are used every day in testamentary instruments, and there should be no reason why they cannot be used in inter vivos documents either. A distinction is that testamentary formula clauses are, in effect, formula allocation clauses. By definition there are always two parties involved other than the testator. However, if the parties are a surviving spouse and children, all of the parties may want as much value as possible transferred to the children, so there may not be an "adverse" party to negotiate about the proper valuation in many testamentary formula marital deduction clauses.
- The clause can have a favorable impact on settlement discussions (and there is anecdotal evidence that has already happened in audits).
- Prof. Jeff Pennell takes the position that the formula transfer approach (using the *Wandry*-type clause) is less abusive than the formula allocation approach with the excess assets passing to charity because the units that remain with the donor will be subject to a future gift or estate tax to the donor. With the formula allocation/charity approach, the excess units are forever removed from the transfer tax base of the donor.
- Some of the planners using a *Wandry* transfer combine that with a formula disclaimer, with the beneficiaries or trustee disclaiming any property in excess of the dollar amount described in the *Wandry* transfer. (See subparagraph (7) below for further discussion of the formula disclaimer approach.)

(6) *Basic Advantages/ Disadvantages of Using Defined Value Clauses*. The basic *advantage* of using the defined value transfer clause is creating the ability to make lifetime transfers without the risk of having to pay current gift taxes (if the clauses work as intended).

Disadvantages include:

(1) whether the defined value clause is a red flag that triggers or intensifies a gift tax audit (for formula transfer or formula allocation-type clauses) [response: with the IRS's consistent losses, using defined value clauses should no longer be perceived as a red flag of an abusive transaction];

(2) complexities of administering the defined value clause (but a "formula transfer" type of clause approved in *Wandry* is easier to administer than a formula allocation among transferees);

(3) a gift tax return must be filed if the clause is based on values as finally determined for federal gift tax purposes (and if the defined value clause is used in the sale ransaction, the seller may have preferred not to report the transaction on a gift tax return);

(4) will a *Wandry* clause cause the gift to be incomplete (because the donor will make decisions in the gift tax audit about value issues and by urging or at least refusing to fight an unreasonably high valuation position by an agent, the donor can cause more of the asset to remain with the donor than should be appropriate); and

(5) if the IRS does not respect the clause, an adjustment of the amount of assets passing to the family trust may still occur (with more assets passing to a charity or other "pourover" party or remaining with the donor under a Wandry-type of clause) even though no tax benefits result from the adjustment.

As to the incomplete gift argument, the wording of the IRS's nonacquiescence could be interpreted to hint that the IRS might raise an incomplete gift issue. The nonacquiescence stated: "nonacquiescence relating to the court's holding that taxpayers made a *completed transfer* of only a 1.98 percent membership interest in Norseman Capital, LLC" (emphasis added). The extent of the donor's control in a gift tax audit seems to be rather remote insofar as retaining dominion and control over the asset to result in an incomplete gift. It is the agent's decisions that cause more of the property to remain with the donor by urging that the property has been undervalued; all the donor can do is decide what to do in response to the agent's decisions. The donor keeps no control whatsoever the keep more of the units than originally anticipated if the agent does not argue that the units were undervalued.)

The last potential disadvantage seems to be the most dangerous in using a *Wandry* defined value transfer of a dollar value. If the IRS does not respect the clause and imposes a gift tax on the number of units that the donor thought was transferred, for state law purposes the formula would still seem to apply (although perhaps that would be grounds for a rescission) and some of the units may remain with the donor to be included in the donor's estate for estate tax purposes. If that happens, it seems there would not be double inclusion because under §2001(b)(last sentence). The units that remain with the donor are obviously included in grantor's gross estate if the donor still owns them at death. The gift tax was calculated as if those units had been transferred. Therefore, under §2001(b) the portion of the adjusted taxable gift attributable to those units that remain with the donor should not be brought back into the estate as adjusted taxable gifts for calculation of the estate tax. (Query what occurs if the donor subsequently makes a gift of those remaining units rather than retaining them until death? Would the transfer be subject to a second gift tax even though the units have already been subjected to a gift tax? Perhaps only the additional value at the time of the second gift would be subjected to gift tax at that time.) Also, if the *Wandry* clause is used in connection with a formula disclaimer, the IRS would have to overcome two issues for this disadvantage to arise.

One situation in which a formula transfer clause could be disadvantageous is if the asset may explode in value in the near future. If that were to happen and if the IRS prevailed in asserting that the value is somewhat higher than reported on the gift tax return, the client might prefer to pay gift tax on the relatively small amount in excess of the gift exemption rather than having some of the units remain in the donor's estate, with the subsequent huge appreciation on those units being added to the donor's gross estate.

(7) *Formula Disclaimer Combined With Wandry Transfer*. Some practitioners using the formula transfer approach recommend that the trust agreement specify that any disclaimed assets will remain with the donor, and that the trustee or donee(s) immediately following the transfer execute a formula *disclaimer* of any portion of the gift in excess of the value that the donor intends to transfer. (A statute in Florida specifically authorizes the validity of such a provision allowing the trustee to disclaim.) The rationale is that the regulations have always recognized formula disclaimers as being valid, so even if the formula transfer for some reason fails to limit the gift, the formula disclaimer will prevent an excess gift. Until further case law develops approving formula transfer clauses, this is a strategy that may provide additional comfort when using formula transfer rather than formula allocation clauses.

If the formula disclaimer approach is used and the disclaimer provision is included in the trust agreement, consider adding a provision in the trust agreement expressing the settlor's wish that the trustee would disclaim by a formula in order to benefit the beneficiaries indirectly by minimizing the gift tax impact to the settlor's family, and perhaps make the transfer to the trust as a net gift so that if gift tax consequences arise they would be borne by the trust. That may give the trustee comfort in being able to disclaim, even though doing so could decrease the amount of assets in the trust. In addition, the formula transfer to the trust in the first place may help give the trustee comfort in making the formula disclaimer despite potential fiduciary concerns; the formula disclaimer is given in order to effectuate the settlor's intent as much as possible in making the formula transfer to the trust. (See Item 5.i.(2) above for a discussion about the effectiveness of disclaimers by trustees.)

One planner suggests that the formula disclaimer by the trustee be combined with provisions in the trust document stating (i) that if an excess value is inadvertently transferred compared to the specified dollar value, the trustee holds the excess as agent for the donor, and (ii) that the trustee may commingle the excess assets that are held as agent with the trust assets.

(8) *Sales with Defined Value Formula Allocation Transfer*. Sale transactions as well as gifts can be structured with a defined value clause. *Petter* and *Hendrix* both involved combined gift/sale transactions. For example, the facts of *Hendrix,* T.C. Memo. 2011-133, lay out a roadmap for how gift/sale transactions can be structured with a formula allocation defined value transfer. The *Hendrix* gift/sale transaction was structured as follows. Each of the parents, the trustees of the GST trust and a charitable Foundation executed an assignment agreement irrevocably transferring 287,619.64 shares of a closely-held corporation, to be allocated between the trust and Foundation under the following provisions:

- Shares worth $10,519,136.12 were allocated to the GST trust;
- The remaining shares were allocated to the Foundation;
- Values were to be determined "as the price at which shares would change hands as of the effective date between a hypothetical willing buyer and a hypothetical

willing seller, neither under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

- The GST trust agreed to pay any gift taxes imposed as a result of the transfer.
- The GST trust trustees would sign promissory notes for $9,090,000 to each parent (thus resulting in a gift to the GST trust by each parent of $10,519,136.12 minus $9,090,000 minus the gift tax attributable to the transfer).
- The parents had no responsibility for allocating the shares under the formula; that allocation was left to the transferees. The dispute resolution and buy-sell agreement would control, thus requiring arbitration if the parties could not agree on the values.

In addition, the formula disclaimer strategy could be used in a sale transaction as well. The trust would specifically permit a trust beneficiary or trust to disclaim any gift to the trust and the trust would provide that the disclaimed asset passes to a charity or back to the donor or to some other transferee that does not have gift tax consequences. After a sale to the trust, the beneficiary would disclaim by a formula the number of units having a value in excess of the specified dollar value of the sale.

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

Similarly, the same principles would seem to apply in structuring a "swap" power under a nonfiduciary substitution power as a dollar value transfer. This could be structured with either the person holding the substitution power or the trust — whichever was transferring the hard to value asset — assigning a formula dollar value of units.

(10) *Will Likely Be Many Audits of Wandry Transfers from 2012 Gift Tax Returns.* Many planners made gifts to utilize their clients' $5.12 million gift exemption in 2012 using *Wandry*-like formulas. Presumably, a number of audits over the next several years of those returns will occur. Some planners have suggested that the IRS may strategically wait to take the next case to court that has some bad facts (indeed, as in *Wandry*) *AND* that would be appealable to the Fourth Circuit.

(11) *Will the IRS Issue Regulations*? The 9th Circuit expressed an invitation for regulations in *Petter*: "We expressly invite the Treasury Department to 'amend its regulations' if troubled by the consequences of the resolution of th[is] case [quoting the U.S. Supreme Court in *Mayo Foundation*, 131 S. Ct. 704, 713 (2011)]." (However, the 9th Circuit was specifically addressing the condition precedent charitable deduction regulation rather than the general public policy/*Procter* issue.) If so, it seems unlikely that the government will try to reverse the clear trend in the cases that have supported defined value transfers and seek to declare that all forms of inter vivos formula provisions are improper. The government understands that many forms of formula provisions are valid — even blessed by them (such as marital deduction formula bequests and formula disclaimers, among others).

However, distinguishing between "good" formula gifts from abusive transactions will be difficult.

(12) *Possible Legislative Response Based on Penalties*. One commentator, who believes that *Wandry* is decided correctly under current law, acknowledges that donors would abuse the system if they purport to transfer a particular dollar value but take an unreasonable valuation position, under the impression that if the IRS audits the return and disagrees on the value, a simple adjustment would occur with no gift tax. If there is concern about the integrity of the system, appropriate better approach, he believes, is to create a penalty. For example, legislation could provide that if the amount initially stated as being the number of units equal to the specified formula dollar value ends up being wrong by more than 20%, a penalty would apply. "That keeps the pigs in line."

(13) *Charity Involvement. Wandry* states explicitly (in two different places in the opinion) that the fact that a charity was not involved does not impact the condition subsequent or the public policy analysis.

McCord, Christiansen, Petter and *Hendrix* all address formula allocation clauses where the "excess amounts" pass to a charity, and some (but not all) of the reasons given for rejecting the IRS's public policy argument apply specifically where a charity is involved. *Hendrix* gives only two reasons for its public policy analysis: that there is no condition subsequent and that public policy encourages charitable gifts. *Christiansen* and *Petter* each have a more robust analysis of the public policy issue, and give additional reasons that the approach would not violate public policy even if a charity were not involved (some of which arguments were repeated in *Wandry)*.

From *Christiansen*: (1) The IRS's role is to enforce tax laws, not just maximize tax receipts; (2) there is no clear Congressional intent of a policy to maximize incentive to audit (and indeed there is a Congressional policy favoring gifts to charity); and (3) other mechanisms exist to ensure values are accurately reported. The court in *Christiansen* reasoned that "the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws." *Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009). In light of the other more robust discussion of the public policy issue in *Christiansen*, it is perhaps significant that *Hendrix* cited *Christiansen* with approval even if it did not repeat all of its public policy reasoning.

From *Petter*: (1) There are other potential sources of enforcement (including references to fiduciary duties to assure that the parties were receiving the proper values); (2) the case does not involve a moot issue because a judgment regarding the gift tax value would trigger a reallocation, and therefore it is not just a declaratory judgment; and (3) the existence of other formula clauses sanctioned in regulations (formula descriptions of annuity amounts for charitable remainder annuity trusts, formula marital deduction clauses in wills, formula GST exemption allocations, formula disclaimers of the "smallest amount which will allow A's estate to pass free of Federal estate tax," and formula descriptions of annuity amounts in grantor retained annuity trusts) suggest there cannot be a general public policy against formula provisions.

e. *Practical Structuring Tips With Wandry Formula Dollar Transfers.*

(1) *Formula Assignment in Wandry May Become Form Template.* The formula assignment that was used in this case (presumably that same form was used by this attorney going back to 2000 when the Wandrys started making these stated value dollar gifts) is very clearly stated and may become a form template that will be used by planners, in light of its specific approval in this case. Anecdotally, one case has been reported in which the agent refused to give effect to a formula transfer clause because it deviated from the precise language that was used in *Wandry*. There's no reason to give an agent that argument (unreasonable though it may be).

John Porter observes that he would change one clause. The *Wandry* clause includes the phrase "a final determination of a different value is made by the IRS or a court of law." That phrase is not as precise as "as finally determined for federal gift tax purposes;" that phrase is clearly defined in §2001(f).

(2) *Gift Tax Return Should Properly Describe the Gift.* In retrospect, the C.P.A. in *Wandry* made a mistake in describing the gift on the gift tax return as a specific number of LLC units. Aside from the public policy argument, the IRS's best argument in this case was that the description of the gift on the gift tax return as a particular number of units of the LLC suggested that the gift was actually of a fixed number of units rather than a fixed dollar value. This is reminiscent of the *Knight* case in which the parties not only listed the gift on the gift tax return as a gift of a stated number of shares, but also argued at trial that the gift was actually less than the dollar value stated in the formula. The facts in *Wandry* were much better than in *Knight* in making clear that the intent was actually to transfer just a stated dollar value worth of units.

The gift tax return properly listed the value of the gifts as the stated dollar values, but the gift description should also make clear that the gift is of the number of units of the LLC having the specified value. The description could state that based on the attached appraisal, the number of units under the formula would be x, but that ultimately the number of units is based on their value as finally determined for federal gift tax purposes.

(3) *More Contemporaneous Appraisal Should Be Made.* The formula assignments were made in this case on January 1, 2004 but the appraiser did not deliver its report until July 26, 2005 — about 19 months later! The appraisal should be prepared fairly contemporaneously with the stated dollar value gift. Waiting 19 months to obtain the appraisal on which the entire transfer is based might cause some courts to refuse to recognize the formula transfer as a bona fide transaction. One wonders, in this case, how the parties allocated profits and losses for 2004. The assignments had been made of member units, but there was no way to determine even the initial allocation of those units for the remainder of 2004. Presumably, the appraisal came in time both to file the gift tax returns as well as the relevant income tax returns, under extension.

(4) *Use a Professional Appraiser*. In all five of the defined value cases (*McCord, Christiansen*, *Petter*, *Hendrix*, and *Wandry*), the taxpayer used a reputable professional appraiser; in the first four cases to prepare the appraisal for purposes of making the original allocation among donees and, in *Wandry*, for the purpose

of determining the number of units actually transferred. This helps support that the taxpayer is acting in good faith and avoid a stigma that the formula transfer is merely a strategy to facilitate (using words of the court in *Petter*) "shady dealing" by a "tax-dodging donor."

(5) *Use Grantor Trusts as Donees.* The government, in making its argument that the capital accounts should control the transfer, rather than the stated dollar values, noted that "if petitioners prevail it will likely require the preparation and filing of numerous corrective returns." That is certainly correct where the donees are individuals, as in *Wandry*. A much preferred planning design is to make the gifts to grantor trusts. Even if the ownership percentages change as a result of a gift tax audit, all of the income and losses will have been reported on the grantor's income tax return in any event, and no corrective returns should be necessary (unless the parties wish to file corrected entity level returns to make clear the appropriate sharing of profits and losses of the entity's owners).

28. GRAT Strategies

GRATs may not be as favored when clients can make gifts of up to $5 million without paying gift taxes and without using sophisticated planning strategies. However, GRATs have the advantage of allowing transfers of future appreciation without incurring gift taxes *or utilizing any gift exemption.* Everything else being equal, it would be advantageous to transfer the desired amount to family members via a GRAT without making any taxable gifts, if possible.

a. *Proposed Legislation.* The Administration's Budget proposal includes various restrictions on GRATs that would disallow several strategies that have been used in the past, including (i) short-term GRATs (under the legislation GRATs would have to have a term of at least 10 years), (ii) front-loaded GRATs, and (iii) very long-term GRATs. (See Items 2.b(3) and 2.d(2) above.) The GRAT provisions have been included in prior legislative bills (though the long-term GRAT prohibition was first added to the Administration's 2012 Budget Proposal), and it is certainly possible that the GRAT proposal will be included as part of a tax reform package sometime this year. Therefore, someone wanting to use any of these strategies should complete implementation of the GRAT before the date of enactment of any such legislation.

b. *Built-In Savings Clause.* For transferring hard-to-value assets, GRATs offer a unique significant advantage of being able to use a built-in valuation savings clause approach that is recognized in the GRAT regulations for the initial transfer to the GRAT. (However, the valuation uncertainties would exist for in-kind payments of the annual annuity amounts if the annuity amounts cannot be made in cash.)

c. *Use Separate GRAT for Each Asset*. If a particular asset transferred to a GRAT does not produce sufficient cash flow, together with the principal of the asset in order to make all of the specified annuity payments, when there is no further value left in the GRAT, it would simply terminate for lack of any trust corpus. If other assets had been gifted to the same GRAT, the other assets would have to be used to make up the deficiencies. In order to avoid this result, it would be desirable to use a separate GRAT for each individual asset (or class of assets) so that poor performance results of one asset will not adversely affect the trust with respect to other assets.

d. *Cap on Remainder; Excess Value Over Prescribed Amount May Be Returned to Grantor*. A parent may own assets that might explode in value (such as stock in a company that may go public in the near future). The parent may be willing to transfer a substantial part of the increase in value, but be leery of transferring "too much value" to his or her children. The GRAT could be structured to provide that the first $X of value at the end of the GRAT term would pass to a continuing grantor trust for children, and that any value in excess of $X would be returned to the grantor, or whatever other arrangement the grantor desires. The formula reversionary provision would have to be included in the GRAT document from the outset.

The right to participate in future distributions will likely result in some (perhaps all — this is unclear) of the GRAT assets being included in the grantor's estate under §2036(a)(1) if the grantor dies during the GRAT term. There may be more estate inclusion than if there is no right to participate in future distributions.

An example in the regulations makes clear that the annuitant may retain a contingent reversionary interest although such a contingent reversionary interest will be valued at zero for purposes of determining the amount of the gift. Treas. Reg. §25.2702-3(e) Ex. 1.

If the grantor survives the end of the GRAT term, this reversionary provision should not trigger §2035 because the grantor takes no voluntary action to relinquish any "string" interest or power that would otherwise case estate inclusion.

In light of the ability to "zero-out" a GRAT under the *Walton* case, the donor has not used any gift exemption by reason of creating the GRAT. Accordingly, there is no particular tax "inefficiency" of having used gift exemption yet having excess value over a specified target amount being returned to the grantor.

This added flexibility is even more apparent if a GRAT is compared to a sale to grantor trust transaction. An inherent uncertainty with the sale approach is knowing how much to sell to the grantor trust in order to transfer a targeted desired amount to trusts for younger generations — because the result depends in large part on how much appreciation will occur in the transferred asset.

In addition, using a GRAT may allow the owner to be more aggressive in transferring a substantial part of a highly appreciating asset to the GRAT, because the grantor can retain the right to receive a certain amount of the trust assets remaining at the end of the GRAT term. For example, parent might transfer almost all of her closely held stock to a GRAT.

e. *Front-End Loaded GRAT*. There is no clear authority for using a one-year GRAT. *See* I.R.C. §2702(b)(1) (referring to qualified annuity interests as amount*s* payable not less often than *annually*; the italicized terms suggest a possible minimum term of two years). *See also Walton v. Commissioner*, 115 T.C. 589 (2000), *acq*. Notice 2003-72, 2003-2 C.B. 964 (approving 2-year GRAT); *Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002) (IRS did not contest validity of 367-day GRAT). A multi-year GRAT may achieve much the same effect as a one-year GRAT if the agreement calls for a substantial payment at the end of year one, and a payment equal to 0.01% of the initial contribution in later years. If the grantor were to die after year one, it appears that the amount to be included in the grantor's estate may be the amount that would be required to produce the annuity of 0.01% — which would be a very small amount. While Treasury Regulation §25.2702-3(e) Ex. 3 clearly allows the amount of the GRAT payment to decrease without limit, no rulings have addressed extreme front-loaded GRATs. Some planners have structured these transactions to have about 90% of the initial value distributed after the first year, leaving a significant payment the second year, in case the

IRS were to argue that a de minimis payment in year two is essentially the same as a one-year GRAT.

f. *Use Revised Spendthrift Clause*. There are two reasons that it may be helpful for the remainder beneficiary to be able to assign its interest in the GRAT. (1) In several recent cases, the IRS was forced to value lottery annuity payments using a lower value than the §7520 value because the annuity payments are nontransferable. Could the IRS argue that the existence of the spendthrift clause means the annuity payments are nontransferable, so that the grantor could not rely on §7520 in placing a high value on the retained annuity payments? (2) It may be helpful for remainder beneficiaries to transfer their interests in the trust (for example, to a GST exempt trust or to the grantor).

g. *Re-Purchase of GRAT Assets by Grantor*. The grantor may re-purchase assets from the GRAT/grantor trust, either prior to or following the end of the initial GRAT term. The low-basis asset in the GRAT would then be in the grantor's estate and would receive a step up in basis at the grantor's death. The GRAT remaindermen would have the cash paid to the GRAT for the low-basis asset, which cash obviously would not have any built-in capital gains tax liability.

h. *Locking In Gains or "Cutting Your Losses"*. If the assets in a GRAT have appreciated substantially, the grantor may wish to take steps to lock in the gain of the GRAT, and not risk that subsequent depreciation would leave the GRAT with no assets to pass to the remaindermen. One way of doing this would be for the grantor to exercise the substitution power by substituting cash for the in-kind asset in the GRAT. If the in-kind asset subsequently depreciates in value, the depreciation would be borne by the grantor, not the GRAT.

A further refinement would be for the grantor to contribute the in-kind asset that has been "purchased" from the initial GRAT to a new GRAT. Future appreciation would then be transferred, but future losses would not reduce the amount of assets that can pass to remaindermen from the initial GRAT.

Similarly, if the GRAT assets have declined in value substantially, the grantor might also exercise the substitution power to substitute cash for the in-kind assets. The grantor could contribute the in-kind assets to a new GRAT, isolating the period of depreciation and harvesting appreciation above the GRAT hurdle rate from that point on in the new GRAT.

An alternate approach (suggested by Edward Manigault) is for the grantor to contribute the annuity from an underwater GRAT to a new GRAT. Presumably, the annuity would be valued at approximately the remaining value in the GRAT. Any subsequent appreciation would inure to the benefit of the new GRAT.

i. *Loans From Separate Grantor Trust*. The $5 million gift exemption opens up the possibility of another strategy that would minimize the valuation risks in making annuity payments. A client might give some of the $5 million gift exemption amount to a grantor trust that will be the remainder beneficiary of a GRAT. When the annuity payment is due, the grantor trust might loan funds to the GRAT which it could use to make the annuity payment, without having to make an in-kind distribution. There would be no gift valuation risk with respect to annuity payments that could be funded with such loan proceeds.

j. *Shelf GRATs*. Because of the legislative proposal to require that GRATs have a minimum 10-year term, some planners suggest currently creating "shelf GRATs." The concept is to create and fund a series of mid-term GRATs currently (say, 4, 6, 8, and 10 year terms), and fund them with fixed income assets. If short-term GRATs are subsequently outlawed, if the §7520 rate rises dramatically for new GRATs, or if the settlor acquires an asset that has high appreciation potential, one of the series of GRATs could be pulled off the "shelf," and volatile assets (with high appreciation potential) could be swapped into the GRAT, in effect resulting in a short-term GRAT (based on the remaining term).

k. *Purchase of Remainder Interest by Grantor*. If there is a really successful GRAT and there is a worry that client might die before the end of the GRAT term, the grantor might consider purchasing the remainder interest from the remainder beneficiary for its present value. If the grantor dies during the term of the GRAT, all assets in the GRAT will likely be included in the estate. But under this approach, the remainder beneficiary trust would have the dollars paid for the remainder interest that are excluded from the grantor's estate. The grantor has no interest in those funds and they would not be included in the grantor's estate for estate tax purposes.

Revenue Ruling 98-8 treated a similar sale of the remainder interest from a QTIP trust as being the equivalent of a commutation. The IRS gave so many reasons in that ruling that it was apparent that the IRS was struggling with a reason that worked. The main rationale in the ruling was §2519, which obviously would not apply outside the context of a QTIP trust. The IRS could similarly assert that the purchase of the GRAT's remainder interest is a prohibited commutation, but it is hard to understand how a commutation can occur without action by the trustee.

If the remainder purchase occurred after the statute of limitations had closed on asserting additional gift taxes with respect to the creation of the GRAT, it may be very difficult for the IRS to attack this transaction. (It would seem that the IRS's only argument would be fraud, on the basis that there was a plan from the initial creation of the GRAT to do something that was not allowed. "There should not be a memo in the file suggesting that the remainder be purchased back after four years.")

One attorney reports doing this in a transaction in which the grantor of a GRAT, who was about to die, purchased the remainder interest from the grantor trust that owned the remainder interest. That sale was audited. In that case, there were different trustees of the grantor trust remainder owner and the GRAT itself (to help show no merger). The attorney even had the grantor trusts file a Form 1041 when initially created, reporting them as grantor trusts. The grantor borrowed money from a bank to pay for the remainder interest. The IRS agent didn't like it, but it passed the audit.

l. *Remainder Purchase GRATs*. Section 2702 generally removes the estate and gift tax advantages of joint purchase transactions. The purchaser of the term interest is treated as initially purchasing the entire property and then transferring the remainder interest while retaining the income interest. The retained income interest is valued at zero because it is not a qualified annuity or unitrust interest. However, if the retained interest is a qualified annuity (or unitrust) interest, it would seem that the actuarial value of the qualified interest could be subtracted in determining the amount of the gift made by reason of the deemed transfer of the remainder interest. See Treas. Reg. §25.2702-4(d), Ex.1 (retained interest in a joint purchase transaction is valued at zero "because it is not a qualified interest"). This raises the possibility of a joint purchase transaction in which the client would purchase a qualified annuity (or unitrust) interest payable from the acquired property and the remaindermen would purchase their remainder interest. *See* Blattmachr & Painter, *When Should Planners Consider Using Split Interest Transfers?*, 21 EST. PL. 20 (1994); PRACTICAL DRAFTING 2482 (Covey ed. 1991). Under the joint purchase approach, the value paid by the grantor for the qualified annuity interest would be excluded from the gross estate, assuming the payment equaled the actuarial value of the retained annuity interest, regardless of whether the grantor survived the term of the annuity interest. (Indeed, an annuity for the grantor's life could be used.)

This approach may also be utilized to achieve generation-skipping advantages if a GST exempt trust is the party paying for the GRAT remainder interest. A twist that would help with the valuation question would be to have the client and grantor trust contribute interests in the same entity (for example an interest in a family limited partnership or LLC). Values would be proportionate to the units transferred by each party. A further twist is to structure the grantor trust that is paying for the remainder interest so that there are non-skip beneficiaries of that trust. In that situation, there would be no GST tax due at the end of the initial GRAT term in any event.

There is obviously a huge premium on getting the values right. If the values are off by even a penny, the full consideration exception would not apply, and there would be a "transferor" for GST purposes.

Several rulings have cast doubt on the ability to use this technique, suggesting that the parent (who contributes an amount equal to the present value of the retained qualified annuity interest) would receive inadequate consideration, citing the reasoning of *Estate of Gradow*, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990). Letter Rulings 9515039, 9412036. However, a variety of cases have recognized sales of remainder interests, and have held that "adequate and full consideration" need only equal the value of the remainder interest transferred by the decedent. *E.g., Estate of Magnin*, 184 F.3d 1074 (9th Cir. 1999); *D'Ambrosio*, 101 F.3d 309 (3rd Cir. 1996); *Wheeler*, 116 F.3d 749 (5th Cir. 1997). *See generally* Jensen, *Estate and Gift Tax Effects of Selling a Remainder: Have D'Ambrosio, Wheeler and Magnin Changed the Rules?*, 4 FLA. TAX REV. 537 (1999); Pennell, *Cases Addressing Sale of Remainder Wrongly Decided*, 22 EST. PL. 305 (Sept/Oct 1995).

In this type of split purchase transaction, the annuity payments should be structured so that the remainder trust pays significant consideration for its interest. There would be real economic substance to the transaction, so that the rationale of the *D'Ambrosio*, *Magnin*, and *Wheeler* "sale of remainder interest" cases would apply.

Even if the rationale of the *Gradow* and *Pittman* (95-1 U.S.T.C. ¶60,186 (E.D. N.C. 1994)) cases do not apply, if the grantor dies during the term of the retained annuity interest, the IRS may attempt to apply the pre-Chapter 14 cases involving private annuity transactions with trusts. Some of those cases suggest that the transferor will be treated as making a transfer with a retained life estate under section 2036(a)(1) if the trust consists of little more than the transferred property and if the annuity payments approximate the amount of anticipated trust income. *E.g., Ray v. Comm'r*, 762 F.2d 1361, 1364 (9th Cir. 1985); Ltr. Rul. 9515039; *but see Fabric Estate v. Comm'r*, 83 T.C. 932 (1984).

Jonathan Blattmachr has written about this type of transaction referring to it as a "SPLAT" (split purchase annuity trust).

m. *Sale of Remainder Interest to Dynasty Trust*. GST exemption cannot be allocated to a GRAT until the end of the GRAT term. One possible planning strategy is to have the remaindermen of a GRAT sell their remainder interests (assuming the GRAT does not have a spendthrift clause that prohibits such transfers) to younger generations or to a GST-exempt trust. *See generally* Handler & Oshins, *The GRAT Remainder Sale*, TR. & EST. 33 (Dec. 2002). If the sale is made soon after the GRAT is created and before there has been any substantial appreciation in the GRAT assets, the remainder interest should have a low value. A concern is that the IRS may argue substance over form and recast the series of transfers as the creation of a GST-exempt GRAT (which is not permitted). The subsequent sale transaction by the GRAT remaindermen should be independent of the initial creation of the GRAT. (For this purpose, it would be best if the GST-exempt trust that purchases the remainder interest is created far in advance of the creation of the GRAT.) Observe that if the remaindermen of the GRAT and the GST-exempt trust that purchases the remainder interest are both grantor trusts for income tax purposes, there should not be any gain recognized as a result of the sale transaction.

The IRS at one time informally indicated its position that it will treat the sale of the remainder interest as a contribution to the trust by the seller so that the trust has two grantors for GST purposes. The portion owned by the seller of the remainder interest is just the small amount paid for the remainder interest. The original grantor is deemed to be the grantor of the balance of the trust (which is almost all of the trust) for GST purposes. Ltr. Rul. 200107015; *Cf*. Treas. Reg. §26.2652-1(a)(1) Example 4 (trust is created for child for life with remainder to grandchild; a transfer by child of his or her income interest will not change the transferor, and parent is still treated as the transferor "with respect to the trust" for GST purposes).

The IRS's approach is to consider the original donor who created the GRAT as a transferor along with the children who assigned their remainder interests to the grandchildren or to a dynasty trust. This argument is analogous to the one the IRS lost in *D'Ambrosio v. Comm'r*, 101 F.3d 309 (3d Cir. 1996), *Wheeler v. U.S.*, 116 F.3d 749 (5th Cir. 1997), and *Estate of Magnin*, 184 F.3d 1074 (9th Cir. 1999). In those cases, the IRS argued that "full and adequate consideration" for the sale of a remainder interest was much more than the actuarial value of the remainder interest. The courts disagreed. Similarly, the gift of a remainder interest by the donor's children should not be treated as something other than a gift solely by the children.

n. *Sale of Annuity Interest by Grantor*. A possible strategy to reduce the risk of the grantor dying during the trust term is for the grantor to sell his or her annuity interest in the GRAT to the remainder beneficiaries. A transfer of a retained interest that would trigger §2036 if held until death generally is subject to the three-year rule of §2035(a), but a sale for full consideration is exempt under §2035(d). Again, the IRS could argue this is a prohibited commutation; a counter argument would be that the trustee is not involved.

o. *Leveraged GRAT*. This strategy introduces leverage into a GRAT transaction, so that it has the leveraging characteristics of sale to grantor trust transactions. A simple straightforward method of introducing leverage would be for the GRAT to borrow as much as possible and invest the borrowed proceeds in assets with appreciation potential. There would be the increased possibility of "hitting a home run" but also a greater risk that the GRAT would implode and that the GRAT would be "underwater." Although that transaction might have a greater likelihood of transferring significant value from the GRAT, it also has high economic risks for the family.

Another way to introduce leverage is to use an existing family investment entity, and leverage that vehicle within the family (but not introducing the added economic risk to the family of outside leverage), so that the *net equity value* contributed to the GRAT is substantially lower, resulting in much lower annuity payments that hopefully can be satisfied out of cash flow if the GRAT has a long enough term.

For example, assume client owns an interest in an FLP.

(1) The client might contribute 10% of the LP units to an LLC in return for units in the LLC, and sell 90% of the LP units to the LLC in return for a 9-year balloon note.

(2) The net equity value of the LLC would be represented by the value of the 10% contributed as a capital contribution. The value of the LLC would be based on the discounted value of the LP units.

(3) The capital interest in the LLC (having a net value, without any discounts, equal to 10% of the value of the total LLC assets) would be contributed to a 10-year GRAT. Because of the discounted value of the LP units and because of the 9-1 leverage of the LLC and because of the ten-year term, the annuity payments may be low enough that the cash flow from the FLP to the LLC and from the LLC to the GRAT may be sufficient to pay the annuity payments in cash.

(4) At the end of the 10-year GRAT term, it would then own all of the capital interests in the LLC.

Sophisticated planners have used this strategy in various situations. It can work particularly well if the client wanted to transfer interests in a private equity fund. The client typically has both a "carry interest" and an "investment interest." The client would contribute both the carry and investment interest to a single member LLC (that is a disregarded entity), partly as a capital contribution and partly as a sale for a note (9-1 ratio). Transferring both the carry and investment interests avoids the application of section 2701. The capital interest in the LLC would be contributed to the GRAT.

This is somewhat comparable to a gift and sale to grantor trust transaction. The leveraged GRAT is better in that the client does not have to use up any significant amount of gift exemption. If the assets do not perform, nothing is transferred to family members via the GRAT, but there is also no wastage of gift exemption (which can occur under a sale to grantor trust transaction if the assets in the grantor trust decline below the amount of the note).

p. *Back to Back GRATs*. Ellen Harrison described a strategy that could use GRATs in a manner that indirectly would benefit the grandchildren's generation. Parent could create a trust for child, and when the child understands the potential transfer advantages and considers the child's own planning, the child might create a GRAT for his or her children. If parent and child both own interests in the same closely-held company, for example, they could each transfer the same number of units in the company to their respective GRATs. In effect, if the parent's GRAT transfers value to child at the end of the GRAT term, the child's GRAT would transfer the same value to his or her children at the end of that same GRAT term. The transactions should be planned as independently as possible to assist in rebutting an "indirect gift" argument by the IRS. If the separate GRATs are part of a pre-arrangement, the IRS might conceivably make an indirect gift/step transaction argument.

q. *Creation of 99-Year Term GRAT*. Turney Berry has suggested the following transaction. Create a 99-year GRAT. With that longer term, the annual annuity payments will be very small. At the client's death, an amount will be included in the client's gross estate under §2036 equal to the small annuity amount divided by the §7520 rate at the date of death. The initial annuity amount is determined based on the current §7520 rate (about 1.0-1.2%). If, by the time of the grantor's death, the §7520 rate has increased, a substantially smaller amount will be included in the grantor's estate. For example, if a long term trusts were created today and the §7520 rates go up to 6% by the time the grantor dies, about 85% of the value will be excluded from the gross estate.

There are various complicating issues with this strategy. First, realize that provisions must be made for paying the estate tax out of assets other than the GRAT. Next, how would family members benefit from the GRAT after the grantor dies? Perhaps the GRAT could be collapsed by bequeathing the annuity interest to the same party that holds the remainder interest, so that there would be a merger of interests under state law. Would that be a prohibited commutation? It doesn't appear to be a standard commutation, but the instrument would, of course, contain the standard prohibition on commutation.

r. *Using Delaware Series LLCs to Facilitate GRAT Transfers*. Using a "Series LLC" can be helpful with using multiple GRATs for different assets or classes of assets. This can also be helpful with using private equity in GRATs so there is no necessity of dealing with third parties when making transfers of the interests in satisfaction of annuity payments. Each series of the LLC can contain a different asset class and can be put into a separate GRAT. When making annuity payments, an interest in a series can be assigned. Also, a defined value formula can be used in making an assignment of a series.

s. *Sale of GRAT Assets to Grantor in Return for Private Annuity*. If the GRAT sells its assets to the grantor in return for a private annuity for the grantor's life, and if the grantor dies during the term of the GRAT, the GRAT would have no assets because the private annuity would expire. The viability of this approach is unclear. The trustee could potentially have fiduciary concerns if the grantor dies during the term and the GRAT ends up with no value. In addition, there could be "economic substance" concerns if there is a pre-arrangement to do this with set values that would pass to the GRAT if the settlor survives the term and that would have nothing in the trust if the settlor does not survive.

29. Remainder Purchase Marital Trusts

The remainder purchase marital trust concept is based on various articles co-authored by David Handler. Handler & Dunn, *GRATs and RPM Annuity Trusts: A Comparison*, 20 TAX MNGMNT EST., GIFTS & TR. J. (July 8, 2004); Handler & Dunn, *RPM Trusts: Turning the Tables on Chapter 14*, TR. & EST. 31 (July 2000).

a. *Basic Description*. The remainder purchase marital trust (referred to below as the "RPM Trust") involves a transfer of assets to a trust in which the donor's spouse has an income or annuity interest for a specified term or life of some individual. (It is important that the spouse is not a beneficiary under an ascertainable or discretionary standard, because that interest would be hard to value; straight income or annuity interests can be valued easily under the IRS's actuarial tables.) The transfer to the trust is gift-tax free because it qualifies for the gift tax marital deduction, even though it is not a general power of appointment trust or a QTIP trust. (See the discussion below about why this is not a "nondeductible terminable interest.") A grantor trust (perhaps a GST exempt trust) for descendants (referred to below as the "Descendants Trust") that was funded by someone other than the spouse pays the donor the actuarial value of the remainder interest when the RPM Trust is created in order to be named as the remainder beneficiary of the RPM Trust. The RPM Trust assets are not included in either the donor's estate (because the donor has no retained interest in the trust) or the spouse's estate (because the spouse does not have a general power of appointment and there was no QTIP election) at their subsequent deaths.

b. *Overall Result*. No gift or estate tax is paid with respect to the trust assets. The Descendants' Trust pays an amount equal to the actuarial present value of the remainder interest when the trust is created (i.e., the full value of property transferred to the trust less the actuarial value of the spouse's income or annuity interest). The present value of the remainder interest may be relatively low compared to the value that the Descendants Trust will ultimately receive. (As with QPRTs, the discount is greater for an RPM Income Trust at higher §7520 rates. However, like for GRATs, the discount is greater for an RPM Annuity Trust at lower §7520 rates.) Thus, the Descendants Trust can acquire assets at significant discounts. The many restrictions that apply to GRATs or QPRTs would not be applicable.

c. *Marital Deduction Terminable Interest Rule*. A transfer to a donor's spouse qualifies for the gift tax marital deduction unless it is a nondeductible terminable interest. Section 2523(b)(1) provides that no gift tax marital deduction is allowed if the spouse receives a life estate or other interest that will terminate at some time *and* if the donor provides that the assets will then pass to someone else "for less than an adequate and full consideration in money or money's worth." As long as the amount passing to the third party is passing for full consideration, the marital deduction is allowed even though the spouse's interest terminates at some point.

d. *Planning Considerations*. For a further discussion of the tax implications and planning considerations for RPM trusts, see Item 14.w of the 2012 Heckerling Musings at http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/01_2012_Heckerling%2520Summary.html

30. Installment Sales to Grantor Trusts and Spousal Grantor Trusts

An installment sale to a grantor trust is a traditionally used strategy for shifting future appreciation, primarily through (1) the grantor's payment of the trust's income taxes under the grantor trust rules, (2) future appreciation of the sold assets in excess of the interest rate on the note to the grantor (typically using the AFR as the interest rate), and (3) fractionalization discounts. For a brief summary of best practices regarding sale to grantor trust transactions, see Item 14 of the 2012 Heckerling Musings (summarizing a panel discussion by John Bergner, Ann Burns and David Handler) at http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/01_2012_Heckerling%2520Summary.html

A corollary strategy is a sale to a "spousal grantor trust." If a sale is made to a grantor trust for the client that is created by the client's spouse, no gain would be recognized on the sale transfer as a result of §1041. As with "standard" sales to grantor trusts, the combined income/appreciation of the trust assets in excess of the small interest rate on the note will be excluded from the client's estate. The client may be particularly willing to engage in transfer planning opportunities with this trust because the client is a discretionary beneficiary of the trust.

A particular tax advantage of this transaction is that the client could be given a power of appointment. If the sale results in a gift element, it would be an incomplete gift. That portion of the trust would continue to be included in the grantor 's estate, but the client would have achieved the goal of transferring as much as possible as the lowest possible price without current gift tax exposure. Gain would not be recognized on the sale, but a downside to this approach is that the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments (although the spouse would likely receive an offsetting investment interest deduction). *Gibbs v. Commissioner,* T.C. Memo 1997-196.

A concern with this approach is that the full appreciation in the asset that is "sold/given" to the trust would be included in the grantor's gross estate, less a §2043 consideration offset for the value of the consideration (i.e., the note amount). A preferable approach would be to use a defined value transfer approach, to transfer a fraction of an asset in the sale transaction. For example, if the asset is believed to be worth $1 million, the formula could transfer a fraction of the asset with a numerator of $1 million and a denominator equal to the finally determined gift tax value the property. The combined defined value clause and incomplete gift trust gives protection against the gift tax and minimizes potential estate inclusion.

Possible disadvantages of this strategy are: (i) a substantial seed gift to the trust will be necessary before the client's makes the sale to the trust; (ii) there is a potential step transaction risk; and (iii) if the client is deemed to be the "transferor" of the property that is sold to the trust, the client's creditors may be able to reach the trust assets.

31. Installment Sales by Beneficiary to Section 678 Trust

a. *Overview.* If the trust does not contain any provisions that would cause the original grantor to be treated as the owner of the trust for income tax purposes under the grantor trust rules, a beneficiary who has a withdrawal power over the trust may be treated as the owner of the trust for income tax purposes under §678. The IRS generally treats 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 holder has interests or powers that would cause §§671-677 to apply if such person were the grantor of the trust (and that is typically satisfied by the reference to §677 if the power holder is also a beneficiary of the trust). See Ltr. Ruls. 201216034, 200949012, 200011058, 200011054 through 200011056, 199942037, & 199935046.

After the trust has been funded, the beneficiary might sell additional assets to the trust in return for a note. If the beneficiary is treated as the owner of all of the trust under §678 for income tax purposes, there would be no gain recognition on the sale. The trust would not be included in the beneficiary's estate and future appreciation in the assets sold to the trust in excess of the low interest charge on the note would be removed from the beneficiary's estate. The decision to transfer value to the trust would be an easy decision because the beneficiary is a discretionary beneficiary of the trust (and could hold a power of appointment with respect to the trust.)

b. *Example of Potential Advantages of This Strategy.* For example, a client's parents might create a trust for the client, and contribute $5,000 to the trust, with a Crummey power that would lapse after 30 days (before any growth occurred). The goal is that the beneficiary would be treated as the owner of the entire trust for income tax purposes under §678. Because the beneficiary never makes a gift to the trust, the trust assets would not be included in the beneficiary's estate under the "string" statutes, the beneficiary could serve as the trustee of the trust, and the trust should not be subject to the beneficiary's creditors if it contains a spendthrift clause. Furthermore, the trust could give the client a broad limited testamentary power of appointment. If the client has a testamentary power of appointment, any gifts to the trust as a result of the IRS asserting that the sale price is insufficient would result in an incomplete gift, not subject to immediate gift taxes. [The trustee could then divide the trust into "exempt" and "non-exempt" portions if the trust has a typical provision authorizing the trustee to divide the trust into identical separate trusts; the incomplete gift portion would be included in the client's estate at his or her subsequent death, but lifetime distributions to the client could first be made out of the non-exempt portion to minimize the estate tax liability.]

In many ways, this is a perfect estate planning vehicle for the client. If the client can build the value of the trust through special investment opportunities, for example, the client can build a source of funds that is available to the client (as a beneficiary) but that is not in the client's estate for estate tax purposes and cannot be reached by the client's creditors. Such leveraging might occur through sales to the trust after the lapse of the Crummey power. In order to provide a 10% (or more) "seeding" of the trust to support the note given by the trust, persons other than the grantor (such as the grantor's spouse or a beneficiary) might give guarantees, paid for by the trust. (An advantage of having the grantor's spouse give the guarantees is that if there is any gift element in the guarantee, that would not prevent having a fully grantor trust during the life of both spouses.) Sales to the trust may be able to take advantage of valuation discounts, and can accomplish an estate freeze by limiting the build-up in the client's estate (that otherwise result from the assets that were sold to the trust) to interest on the note.

The trust can deplete the client's other estate assets to the extent that the client pays income taxes on the trust income out of other assets. The depletion aspect is not as dangerous as other grantor trusts where the grantor may be subject to paying larger income taxes than anticipated; in this situation, the client is also a beneficiary of the trust, so distributions may be made to the client to assist in making the income tax payments after the client has "burned" as much of his or her other assets as desired through the income tax payments. Richard Oshins, of Las Vegas, Nevada, refers to this as incorporating "a freeze, a squeeze, and a burn." The freeze is the obvious freeze of future appreciation on assets acquired by the trust, the squeeze is taking advantage of valuation discounts, and the burn is depleting the client's other assets in making the income tax payments. In order to make a substantial sale to the trust that has been funded with a relatively small amount by the client's parents or other relatives, the planner may decide to use guarantees and to have the trust pay fair value for the guarantees. For an excellent discussion of planning considerations, see Oshins, *The Beneficiary Defective Inheritor's Trust ("BDIT")* (2008).

c. *Recent Letter Ruling*. A recent private letter ruling was consistent with the prior rulings that have ruled that the trust is treated as owned by the Crummey power holder/beneficiary under §678. Ltr. Rul. 201216034. In that ruling the beneficiary had a non-fiduciary substitution power, and the ruling reasoned that the existence of the non-fiduciary substitution power constituted the requisite retained interest or power that would cause §675 to apply if the power were held by the grantor. That ruling, like many of the other rulings issued by the IRS acknowledging that §678 applies to the trust, involved a trust that held S corporation stock, and the ruling held that the trust was a qualified shareholder of the S corporation, because it is a grantor trust.

The ruling appears to be wrong — because the existence of the beneficiary's non-fiduciary substitution power causes the trust to be a grantor trust as to the *original* grantor (and §678(b) makes clear that the trust is not treated as owned by the power holder under §678(a) if the original grantor is treated as the owner). The IRS has made clear that third-party substitution powers (held by someone other than the grantor) cause the grantor trust rules to apply as to the grantor. Rev. Proc. 2007-45. (Letter Ruling 9311021 similarly concluded (apparently inadvertently and incorrectly) that a trust with a third party substitution power was a grantor trust as to the holder of the substitution power.)

d. *IRS No-Ruling Position.* There have been informal indications from the IRS that the IRS is likely to continue to give favorable §678 rulings for a trust that receives or purchases S corporation stock. The IRS will no longer issue §678 "comfort" rulings in other situations to trusts about to engage in leveraged transactions.

The IRS formally announced in Rev. Proc. 2013-3 that it will no longer issue private rulings that the trust assets in this type of situation will be excluded from the beneficiary's estate under §§2035, 2036, 2037, 2038 or 2042, that the sale will not be treated as a taxable gift under §2501, or that §2702 will not apply. This no-ruling position applies in situations in which the beneficiary meets the requirements of §678 to be treated as the owner of the trust and sells property to the trust for a note, and "the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property that is purchased." Rev. Proc. 2013-3, §§4.01(48)-(52), (55), 2013-1 IRB 113 (Jan. 2, 2013).

e. *Summary of Tax Risks.* (i) There is a risk of estate tax inclusion under §§2036 and 2038 if the sale is not deemed to be a "bona fide sale for an adequate and full consideration." Reporting the sale on a gift tax return that meets the adequate disclosure requirements may assist in providing cover as to this issue. (ii) If the seed gift is insufficient to support the note, having another trust guarantee the note in exchange for fees may be necessary. (iii) If such guarantees are unreasonably high compared to the net value of the trust, courts may view that as an indication that the sale is not a "bona fide" transaction for purposes of §§2038 and 2038. (iv) If the beneficiary is deemed to be the "transferor" of the property that is sold to the trust, the beneficiary's creditors may be able to reach the trust assets. Therefore, creating the trust in a self-settled trust state may be advisable.

f. *Selected Technical Issues*. The IRS's position under §678(a)(2) as to lapsed powers may be questioned because that section confers grantor trust status following the "release or modification" of a withdrawal power. This arguably is not the same as the mere lapse of a withdrawal power. A "release" requires an affirmative act whereas a "lapse" is a result of a passive nonexercise of a power. Furthermore, the gift and estate tax statutes make a distinction between lapses and releases. [Sections 2041b)(2) and 2514(e) provide that "the lapse of a power … shall be considered a release of a power."] Despite this argument, the IRS clearly treats the beneficiary as an owner of the trust with respect to lapsed withdrawal rights.

A further complication is that under §678(a), grantor trust treatment applies to "any portion" of a trust as to which the power of withdrawal exists and has been released while reserving control that would cause §§671-677 to apply if such person were the grantor of the trust. The regulations discuss the "portion" issue in Treas. Reg. §1.671-2(e)(6) Ex. 4.

In that example, the beneficiary holds an unrestricted power to withdraw "certain amounts contributed to the trust." The example concludes that the beneficiary is treated as an owner of "the portion of [the trust] that is subject to the withdrawal power." Some planners believe that the "portion" refers to a fractional interest rather than an amount, so that if all gifts are subject to withdrawal power by the beneficiary, the entire trust would be treated as owned by the beneficiary under §678. However, the term "portion" might refer to the amount that can be withdrawn by the beneficiary, which would exclude growth in the trust from the time of the contribution to the time of the release of the withdrawal right. Under that view, if the initial contribution of $20,000 is covered by a withdrawal power, but the trust is worth $100,000 at the beginning of year 2, only 20,000/100,000, or 20% of the trust would be treated as owned by the beneficiary in year 2. [Observe that under this approach, in all of the private letter rulings that have been issued treating the Crummey power holder as the owner of a trust owning S stock, there would no longer be a wholly grantor trust if there were any growth in the assets before the withdrawal power lapsed, which would cause the trust no longer to be a qualified S shareholder under the grantor trust exception. None of the S stock/Crummey trust PLRs have even hinted at that limitation. Furthermore, this approach would require revaluing Crummey trusts each year in order to determine the portion of the trust hat is attributable to the power holder and the portion that is attributable to the trust. It presents an administratively unworkable reporting requirement.]

32. Sale of S Corporation Stock by Beneficiary to QSST

If a beneficiary consents to a qualified subchapter S trust (QSST) election, the beneficiary "is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election is made." Reg. §1.1361-1(j)(8), referring to §1361(d)(1). Accordingly, the beneficiary is taxed on the K-1 income of the trust from the S corporation. Could the beneficiary also sell additional S stock in that same corporation to the trust and avoid having the sale treated as a taxable transaction? Presumably that is allowed because the beneficiary is treated as the owner of the portion of the trust holding the S stock — both before the sale and after the sale of additional S stock to the trust. (Rev. Rul. 85-13 said that a sale by the grantor to a trust that was not a grantor trust in return for a note without adequate security caused the trust to become a grantor trust and shielded that very sale from being a taxable sale. This seems to be an easier situation because the trust indeed is a grantor trust as to the S stock both before and after the sale.) However, note that the QSST regulations do not explicitly address whether a sale to the trust of additional S stock in the same company by the consenting beneficiary will be taxed as a sale by the beneficiary to the beneficiary's grantor trust — and therefore non-taxable.

The strategy has advantages over the sale to §678 trust described above because there is no $5,000 limit that might otherwise apply to contributions to "seed" the trust, there are no technical issues regarding the "lapse" or "partial release" of a power of withdrawal. Being able to have considerably more value in the trust prior to the sale assists in defending against potential §§2036/2038 arguments about the bona fides of the sale.

If the beneficiary sells S corporation stock to the QSST in return for a note, it is imperative that the stock serve as collateral for the note. A QSST must distribute all net accounting income as determined under state law to the beneficiary, §1361(d)(3)(B), referring to §643(b). A sale of S stock to a QSST raises the question of whether distributions from the S corporation to the trust must be entirely distributed to the beneficiary or whether some portion could be used to make principal and interest payments on the note. The interest payments should be fine — because they reduce net accounting income that must be distributed to the beneficiary. Some portion of the payment may also be used to make principal payments, as summarized by Stacy Eastland:

> The distributions on the purchased Subchapter S stock can also be used by the trustee of the QSST to retire the principal on the note, if the distributions are security for a note on which the QSST is the obligor. Compare the interaction of Secs. 502(b) and 504(b) of the Uniform Principal and Income Act. There may need to be an equitable adjustment between the principal and income of the trust when the distributions from purchased Subchapter S stock are used by the trustee of the QSST to retire principal of the debt used for that purchase, depending upon the interaction of Secs. 502(b) and 504(b)(4) of the Uniform Principal and Income Act. The fact that Subchapter S distributions are part of the security for the debt, and are used to retire the principal of the debt, does not disqualify the trust from being a QSST [citing Ltr. Ruls. 914005 and 200140046].

33. Transfers Involving Family Limited Partnerships or LLCs

a. *Family Limited Partnership/LLC Planning Checklists*. Stephanie Loomis-Price (Houston, Texas) suggests the following checklists for properly maintaining FLPs/LLCs and structuring transfers of interests in FLPs/LLCs.

(1) *Weakest Link*. Sound advice to clients is that the strength of a family limited partnership is determined by the weakest link in the structure and implementation of the partnership. Very often, planning and structuring of the partnership is excellent, but significant problems arise in the implementation, administration, and maintenance of the partnership over the years.

(2) *Post Formation Audits*. Consider conducting post-formation audits of FLPs. When a tax controversy arises, the client who created and funded the FLP is probably not going to be available. It will be the advisors who will explain the purpose of the FLP and how it was operated. Some planners prefer to schedule partnership meetings and prepare minutes of the meetings describing activities of the partnership.

(3) *Checklist of Ideas for FLP Maintenance.*

- File required annual filings; memorialize all significant partnership decisions.
- Comply with the terms of the partnership agreement.
- Comply with loan terms, if loans are made.
- Make any distributions pro rata (and pursuant to terms of the partnership agreement).
- Refrain from the personal use of partnership assets (at least unless fair rental is paid) or using assets for the partners' personal obligations.
- Refrain from having the partners individually pay partnership obligations.
- Encourage partners to maintain current and accurate books and records.
- Avoid the following as recurring transactions between the partners and the partnership: loans, redemptions, non-regular distributions, non-pro rata distributions.
- Review the non-tax reasons for forming the partnership and follow them.

- Establish a protocol for administering the partnership in accordance with the requirements of the agreement.

(4) *Checklist of Ideas Regarding Review of Transfers of FLP Interests.*

- Review books and records of the partnership prior to transfers.
- Amend the Certificate of Limited Partnership if necessary.
- Execute appropriate transfer documents concurrent with transfers to the FLP.
- Consider the effect of transfers if a §754 election is in effect.
- Wait until after the partnership is fully funded and operational to begin gift planning.
- Abide by transfer restrictions in the partnership agreement.
- Carefully consider tax consequences of transfers.
- Retain the services of an independent and qualified appraiser.
- Encourage open communication with appraisers; do not conceal information from the appraiser.
- Be specific about what interests need to be valued.
- Be aware of IRS settlement guidelines.
- Do not round down on appraisals and returns.
- Carefully review the appraisal report and request revisions if it is not easy to understand.

b. *Marital Deduction Mismatch General Issue If §2036 Applies to Married Decedent.* The general marital deduction mismatch issue arises when assets are included in the gross estate of the first-decedent spouse. The IRS has argued in several cases that while the full asset value is included in the gross estate, all the estate has to leave to the surviving spouse is a limited partnership interest (because it does not own the partnership assets directly), and that a marital deduction should be allowed only for the discounted value of the limited partnership interest. That is all the estate owns to "pass" to the surviving spouse, as described in §2056. In effect, the IRS argues that the tax fiction that applies for purposes of the value to be included in the gross estate under §2036 should not also apply consistently for purposes of the marital deduction. The IRS has made this argument in *Estate of Black v. Commissioner*, 133 T.C. 340, 342 (2009) and *Estate of Shurtz v. Commissioner*, T.C. Memo. 2010-21. The court did not have to address the marital deduction mismatch issue in either of those cases because the court held that §2036 did not apply in those cases. Footnote 5 of "*Turner II*" [138 T.C. No. 14 (2102)] briefly discusses the marital deduction mismatch issue and the Tax Court's prior references to the issue in *Estate of Black* and *Estate of Shurtz.*

The court observes that the general marital deduction mismatch issue does not arise in this case, because the government's computation for entry of decision

> allowed an increased marital deduction that he calculated on the basis of the value of assets transferred in exchange for the partnership interests that Clyde Sr. held at death, rather than on the basis of the discounted values of the general and limited partnership interests that Clyde Sr. owned at death, to the extent that they passed to Jewell. The estate recognizes that, and *we leave this mismatch problem for another day*. (Emphasis added.)

It is not clear whether the IRS inadvertently failed to raise the valuation mismatch argument. Perhaps it did not do so because the surviving wife was the sole general partner and the agreement may have permitted her unilaterally to decide to liquidate the partnership at any time.

For an excellent discussion of the marital deduction mismatch issue and *Turner II*, see Blattmachr, Gans & Zeydel, Turner II *and Family Partnerships: Avoiding Problems and Securing Opportunity,* 117 J. TAX'N 32 (July 2012) and Loomis-Price & Angkatavanich, Turn(er)*ing the Tables on Taxpayers: The Marital Deduction Mismatch Strikes Again,* TRUSTS & ESTATES 18 (July 2012). Among other things, the Blattmachr, Gans & Zeydel article discusses possible planning strategies to avoid the marital deduction mismatch issue, including (1) providing in the partnership agreement and in any trust to which a partnership interest is transferred that if the interest is included in a married deceased partner's estate, the interest would pass in a form qualifying for the estate tax marital deduction (a "contingent marital deduction provision" as routinely found in irrevocable life insurance trusts), and/or (2) stating in the partnership agreement that with respect to any partnership interest inherited by the surviving spouse, he or she would have "a unilateral right to 'put' the partnership units to the partnership in exchange for a pro rata portion of the underlying partnership assets to the extent the underlying partnership assets are included in the deceased spouse's gross estate." *Id.* at 44. As to the put right strategy, also see Matz, *Special Concerns in FLP Planning Where Both Spouses Are Living*, 34 EST. PL. 16 (Jan. 2007).

c. *Strategy for Transfers to FLP/LLC To Achieve Valuation Discounts With Minimal §2036 Risk*. Jonathan Blattmachr suggests the following strategy to minimize the §2036 risk. One spouse (for illustration purposes, assume the Wife) forms a small limited partnership. Wife's general partnership interest would allow her to liquidate the partnership at any time pursuant to the terms of the partnership agreement. Husband makes a very large contribution to the partnership as a gift to Wife that qualifies for the marital deduction. Rev. Rul.71-443, 1971-2 C.B. 337, relying on reasoning of Reg. §25.2511-1(h)(1)(gift to corporation is treated as proportionate gift to the shareholders). If Husband predeceases Wife, §2036 should not apply because he retained no interest or control. At Wife's death, even though she received large distributions from the partnership, the only interest that would be included in her estate under §2036 would be the interest that is attributable to her small initial contribution. If Wife leaves her interest in the partnership to Husband, §2036 could not apply at Husband's subsequent death to the interest that Husband receives from Wife by inheritance from her. Rev. Rul. 84-179, 1984-2 C.B. 195, adopting the rationale of *Estate of Skifter*, 468 F.2d 699 (2d Cir. 1972) (testamentary transfer from donee-spouse to original transferor spouse viewed as unrelated to initial transfer).If Husband later sells or gives the general partnership interest to assure that partnership interest would not be valued in his estate on a liquidation basis, §2035 should not apply because §2036 cannot apply to that transfer since Husband did not make a transfer in return for the general partnership interest.

The effect of this strategy is that a happily married couple could create an FLP or LLC without §2036 risk and be able to achieve valuation discounts at the death of the surviving spouse when estate taxes would be due. The strategy is explained and analyzed in detail in Blattmachr, Gans & Zeydel, Turner II *and Family Partnerships: Avoiding Problems and Securing Opportunity,* 117 J. TAX'N 32 (July 2012).

d. *Strategy to Be Able to Purchase FLP Assets Without Gain Recognition.* Assume that an individual has created a family limited partnership and has made gifts or sales of limited partnership interests to a grantor trust. The client wants to keep the FLP intact, but is concerned that there are low basis assets inside the partnership. Jonathan Blattmachr suggests that the partnership should be structured as a disregarded entity. The general partnership interest would be a grantor trust, and the limited partnership interest would be held either by the client or in another grantor trust that would receive limited partnership interests by gifts or sale. Because the partnership is a disregarded entity, the client can purchase assets from the partnership for cash or other high basis assets without any gain recognition.

e. *What Situations Can Satisfy the Bona Fide Sale Exception to §2036?* Courts now use the standard for the bona fide sale exception to §2036 for FLPs that was announced in *Bongard v. Commissioner* [124 T.C. 95 (2005)] — there must be a legitimate and significant nontax reason for the partnership. If the planner wishes to avoid §2036 with respect to assets contributed to an FLP, see if one of the following special circumstances might apply to the specific facts of the family situation. These are the special situations that have been recognized by cases as meeting the "legitimate and significant nontax reasons" test.

- Large block of voting stock in closely held corporation, *Black v. Commissioner*
- Joint management and keeping a single pool of assets for investment opportunities, patent royalties and related investments, *Mirowski v. Commissioner*
- Closely held business; resolution of family litigation regarding active management of closely held business, *Stone v. Commissioner*
- Maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests, *Kimbell v. United States*
- Perpetuating buy-and-hold investment philosophy for du Pont stock, *Schutt v. Commissioner*
- Preserve family ranching enterprise, consolidate undivided ranch interests, *Church v. United States*
- 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, *Bongard v. Commissioner*
- Continue investment philosophy and special stock charting methodology, *Miller v. Commissioner*
- Protect family assets from depletion in divorces, *Keller v. United States*
- Centralized management and prevent dissipation of family "legacy assets," *Murphy v. Commissioner*
- Asset protection and management of timberland following gifts of undivided interests, *Shurtz v. Commissioner*
- Managing woodland parcels as a family asset for later development and sales of lakeside homes, *Stone v. Commissioner*
- Ensuring equal distribution of estate among children thereby avoiding litigation, effective management and minimizing potential liability for operation of quarries and other real estate properties requiring active management, *Kelly v. Commissioner*

f. *"Scorecard" of §2036 FLP Cases (13-21, With 2 on Both Sides)*. Of the various FLP/LLC cases that the IRS has chosen to litigate, thirteen have held that at least most of the transfers to an FLP qualified for the bona fide sale exception. Including the partial inclusion of FLP assets in *two cases,* 21 cases have held that §2036 applied to FLP or LLC situations. For a listing of these respective cases, see Item 17.c of the summary at http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/12_2012_Estate%2520Planning%2520Current%2520Developments.html

34. Estate Planning For Large Estates Over $15 Million

An outstanding panel discussion at the 2012 Heckerling Institute on Estate Planning by Ann Burns (Minneapolis, Minnesota), John Bergner (Dallas, Texas) and David Handler (Chicago, Illinois) addressed planning approaches and alternatives for hypothetical clients with large estates. The discussion addressed not only technical tax issues and best practices tips for various planning alternatives but an analysis of deciding which types of strategies are most appropriate for various different types of assets and family situations. For a summary of a truly outstanding discussion of planning considerations for large estates see Item 14 of the 2012 Heckerling Musings at http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/01_2012_Heckerling%2520Summary.html This 10-page summary of sophisticated estate planning strategies and considerations for large estates is a wonderful resource (no thanks to me—all I did was summarize the excellent pithy panel discussion).

35. Intra-Family Loans and Notes

a. *Examples of Uses.* Examples of intra-family loans and notes include loans to children or grantor trusts, sales to children or grantor trusts for notes, loans between related trusts (for example to freeze the value of a Marital Trust or GST non-exempt trust), home mortgages for family members, loans for consumption, loans from children to parents for relatively high interest rate notes, and notes to document loans that a client borrows from a gift trust in case the client later has liquidity needs or needs to borrow funds in order to pay income taxes with respect to the grantor trust income.

b. *Advantages.* Intra-family loans present a very simple alternative for transferring significant value through the arbitrage of using very low interest rates (i.e., the AFR). For example, using the December 2012 mid-term AFR of 0.95% for a $1 million loan to a child in return for a nine-year balloon note, about $462,000 would be transferred to the child if the child can invest the assets to return 5% per year. Other advantages include that interest payments remain within the family, the loans may present the only financing available for family members with poor credit history, and formal closing costs the banks would require could be avoided. If loans are made to a grantor trust, there would be no recognition of interest income or the complexity of OID computations.

c. *Upfront Gift If Intent to Forgive Loan?* Revenue Ruling 77-299 concludes that if a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect the note, the note will not be considered valuable consideration and the donor will have made a gift at the outset to the full extent of the loan. There were prior contrary cases. The better approach seems to be that, even if there is an intent to forgive the note payments from the outset, the transfer should not be treated as a gift initially. (1) The donor is free to change his mind at any time, (2) his interest in the note can be seized by a creditor or bankruptcy trustee, who will surely enforce it, and (3) if the lender dies, his executor will be under a duty to collect the note. However, the IRS position is clear from

Rev. Rul. 77-299. If there is no prearranged plan and the intent to forgive the debt arises at a later time, the donor will have made a gift only at the time of the forgiveness. Rev. Rul. 81-264.

d. *Structure Loan as a Bona Fide Loan.* The IRS presumes a transfer of money to a family member is a gift, unless the transferor can prove he received full and adequate consideration. Avoid the IRS gift presumption by affirmatively demonstrating that at the time of the transfer a bona fide creditor-debtor relationship existed by facts evidencing that the lender can demonstrate a real expectation of repayment and intention to enforce the debt. Treatment as a bona fide debt or gift depends on the facts and circumstances. A wide variety of cases, in various contexts, have addressed what is required to establish that the loan is a bona fide loan rather than an equity transfer. *E.g. Estate of Lockett v. Commissioner,* T.C. Memo. 2012-123. Factors that help to establish that the loan is bona fide include the following: sign a promissory note; establish a fixed repayment schedule; use a reasonable interest rate (the AFR should do), secure or collateralize the debt; expect and demand repayment; maintain records that reflect a true loan transaction; repayments are actually made; borrower solvency; and do not have a prearranged schedule to forgive the loan.

e. *Use an Interest Rate at Least Equal to the AFR for Cash Loans.* Under §7872 a demand or term loan with an interest rate at least equal to the AFR (determined under §1274) is not a below market loan. Sections 1274 and 7872 (passed soon after the *Dickman* Supreme Court case) seems to contemplate cash loans between individuals, but under case law the exchange of property for a note is also determined under §7872 and as long as the loan bears interest at a rate equal to the AFR for the month in question, there is not a deemed gift attributable to the note. *See Frazee v. Commissioner*, 98 T.C. 554, 588 (1992); *True v. Commissioner*, T.C. Memo. 2001-167, *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004). There is no explicit authority for using the AFR for loans between trusts, though the concepts seem to apply.

Section 7872 addresses the gift and income tax consequences of using a below market note. Forgone interest is computed by comparing the present value of all payments due under the loan (discounted using the appropriate AFR) and with the actual loan amount; if the present value is less, there is forgone interest. Forgone interest is deemed to have been transferred from the lender to the borrower as a gift, and then from the borrower to the lender as interest income.

Income tax treatment: The forgone interest is imputed as interest income on the last day of each taxable year.

Gift tax treatment: For demand loans, the foregone interest each year is deemed to be given on December 31 (or when the loan is repaid). For term loans, 100% of the foregone interest is treated as a gift upfront when the loan is made.

f. *Generally Use Term Loans Rather Than Demand Loans*. For a demand loan, the stated interest rate is compared to the AFR throughout the loan, and gifts will result for any period during which the stated interest rate is less than the AFR for that period. For term loans, however, the stated interest rate is compared to the AFR at the time the loan is originated to determine if the loan results in a gift. In light of this treatment, using term loans has two distinct advantages. (1) There is no complexity of repeatedly determining the appropriate AFR for any particular period, but the AFR at the origination of the loan controls. (2) During the current incredibly low interest rate environment, there will be no gift tax consequences for the entire term of the note as long as the interest rate of the term note is at least equal to the AFR when the note is originated.

g. *How to Determine Interest Rate for Demand Loans and Term Loans*. For demand loans, use the lower of the short-term AFR in effect the month the loan is made or the 1st month of the semiannual period (January or July). The rate is reset every 6 months to the short-term AFR for January and July. For loans that remain unchanged during the year, the interest is computed using the annual Blended rate (published annually in the July AFR ruling issued about June 20 – the 2012 Blended Rate is 0.22%).

   For term loans, the appropriate AFR is the rate in effect for the month the loan is made based on the term of the loan: short-term (3 years or less); mid-term (over 3 years but less than 9 years); long-term (over 9 years). The rate continues to apply over the life of the loan despite future rates fluctuation. For sales transactions, the appropriate AFR is based not on the term of the note but its "weighted average maturity," and the lowest AFR for the 3 months ending with the sale date can be used. I.R.C. §1274(d)(2)(3-month provision); Treas. Reg. §1.1274-4(c)(weighted average maturity description).

h. *Accrued Interest Generally Must be Recognized Each Year Even by Cash Basis Taxpayers*. If a note requires interest at the AFR but the interest accrues and is not actually payable each year, the original issue discount (OID) rules will apply. There are a few exceptions to the OID rules, but generally the OID rules require that a pro rata amount of the overall amount of the OID over the life of the loan must be recognized each year as ordinary income, even for cash basis taxpayers. §1272(a). The OID complications are avoided if the loan/note transaction is between a grantor and that person's grantor trust.

i. *Forgiving Debt Should Not Result in Income Recognition to Borrower and May Not Result in the Seller Having to Recognize Accrued But Unpaid Interest as Income.* The borrower should not have discharge of indebtedness income if the note is forgiven because §102 excludes gifts from the definition of gross income. *Helvering v. American Dental,* 318 U.S. 322 (1943).

   The seller may not have to recognize accrued interest as income. By negative implication, the proposed regulations indicate that accrued interest under a note providing stated interest will not be recognized as income if the accrued interest is forgiven as long as the forgiveness "include[s] in substantial part the loan principal." Prop. Reg. §1.7872-11. The proposed regulations have been outstanding for decades but have never been finalized. However, these regulations appear to provide a reporting position that the lender will not have to recognize the unpaid interest (that has not previously been recognized under the OID rules) that is forgiven if the forgiveness includes "in substantial part" the loan principal. Do not consistently forgive accrued interest each year; that may be a factor in determining whether there is a bona fide loan.

j. *Discounting Notes in Subsequent Transactions May Be Possible*. Under gift and estate tax regulations, the value of a note is the unpaid principal plus accrued interest, unless the evidence shows that the note is worth less (e.g., because of the interest rate or date of maturity) or is uncollectible in whole or in part. A wide variety of cases have valued notes at a discount from face based on satisfactory evidence. The clear implication of §7872 is that a transfer for a note that bears interest that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note.

The estate tax regulations indicate that a note can be discounted based on the note's interest rate if interest rates generally rise by the time of the holder's death. Even if general interest rates do not change between the time the note is given and the date of death, can the note be discounted because the AFR, which is the test rate for gift tax purposes under §7872, is an artificially low rate — the rate at which the United States government can borrow? There are no cases or rulings. A proposed regulation under §7872 suggests that such discounting, merely because the AFR is an artificially low interest rate, would not be allowed. Prop. Reg. §20.7872-1. However, that regulation has never been finalized. *Be aware, however*, the IRS estate tax agent may feel that taking a discount merely for this reason is abusive (because the note was not similarly discounted for gift tax valuation purposes at the time of the sale) and may closely scrutinize every aspect of the loan or sale transaction. Also, beware that the income tax effects of discounting the note may offset or even outweigh discounting the note for estate tax purposes. When the note is paid, the excess payment over the note's basis is generally treated as ordinary income.

k. *Refinancing Notes to Utilize Lower Interest Rates.* There are no cases, regulations or rulings that address the gift tax effects of refinancing notes. Proposed regulations under §7872 include a section entitled "Treatment of Renegotiations," but merely reserves the subject for later guidance, which has never been issued. Commentators have generally concluded that refinancings at lower AFRs should be possible without gift consequences. *See* Jonathan Blattmachr, Elisabeth Madden, & Bridget Crawford, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. TAX'N 21 (July 2008). Refinancing at lower current interest rates should be permissible, but do not get greedy and do this repeatedly. To be more conservative, make some modification in return for the lender's agreeing to refinance at the lower interest rate, such as paying down some principal, reducing the term of the loan, or adding collateral.

l. *Planning Issues With SCINs.* A self-canceling installment note (SCIN) is a debt obligation containing a provision canceling the liability upon the death of the holder. If the holder dies prior to the expiration of the term of the SCIN, the automatic cancellation feature may operate to remove a significant amount of assets from what would otherwise be includable in the estate of the holder.

Planning with SCINs followed the seminal case of *Estate of Moss v. Commissioner*. 74 T.C. 1239 (1980), *acq. in result*, 1981-1 C.B. 2 (remaining payments that would have been due following the maker's death under a SCIN were not includable in the decedent's gross estate under §2033).

The IRS has never given guidance as to how to calculate the premium attributable to the cancellation feature of the note. There are no PLRS explaining the mathematics. Three commercial software programs, ZCalc, Tiger Tables (developed by Larry Katzenstein) and Leimberg's NumberCruncher all reach the same answer, and they all calculate the premium independently. As a practical matter, the IRS probably uses the same software programs to calculate the premium that the rest of us use.

If the SCIN is cancelled by reason of the death of the seller during the note term, any deferred gain will be recognized as income. In *Estate of Frane v. Commissioner,* the Tax Court held the income would go on the deceased seller's final return, 98 T.C. 341, 354 (1992), but the Eighth Circuit reversed and held that the estate would realize the income, 998 F.2d 567 (8th Cir. 1993). Having the income recognized on the decedent's final return would generally be preferable, so that the resulting income tax liability should be deductible as a §2053 claim against the estate for estate tax purposes. The Eighth Circuit's position has not been adopted by any other Circuits. An argument can be made that the gain should be recognized by the seller on his or her final income tax return in accordance with the Tax Court decision and §453B(f).

There is uncertainty regarding the determination of the note's basis. Is it the amount of the payments as determined initially or if the note is canceled because the person dies before the end of the note term, is the basis the total amount actually paid?

m. *Loans Involving Estates; Graegin Loans.* In *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477, the Tax Court in a memorandum decision allowed an estate to deduct projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation, where the loan was for a fixed period, with a set interest rate, with a large prepayment penalty to assure the loan would remaining outstanding during its entire term. T.C. Memo. 1988-477. Various subsequent cases have similarly allowed deducting projected interest on "*Graegin* loans." *E.g. Estate of Duncan v. Commissioner,* T.C. Memo. 2011-255. However, some cases have refused to allow the interest deduction (if the IRS convinced the court that the only purpose was to generate an estate tax deduction). *E.g., Estate of Black v. Commissioner,* 133 T.C. 340 (2009).

The Treasury Priority Guidance Plans for 2009-2012 include a project to address when present value concepts should be applied to claims and administration expenses (including, for example, attorneys' fees, Tax Court litigation expenses, etc.). Graegin notes are also in the scope of that project.

36. Planning Considerations for Dealing With Digital Assets

a. *Significance, Digital Assets Are Widespread.* Many if not most individuals have multiple computers, cell phones, iPads, iPods, Nooks or Kindles, and are on Facebook (and perhaps LinkedIn or Twitter), have a Netflix account, have thousands of digital pictures, multiple email addresses. Some assets may be stored in the Cloud. There are various online accounts, including stock accounts, bank accounts, airline travel accounts, and participation in various reward programs. The individual may own websites. There can be a PayPal account with value in it.

b. *Challenges.* The first challenge is finding the person's valuable or significant digital property. The second challenge is that these accounts, records, and digital property may be protected by passwords and encryption. The third challenge is that federal and state criminal and data privacy laws may be significant obstacles to reaching digital property. (The privacy laws require that the user consent; consent by the fiduciary on behalf of a decedent is not sufficient. Even with consent, disclosure is voluntary and many providers will not release information to anyone other than the registered account holder.)

c. *Identification; Inventory of Digital Assets.* This information is vital for the family and vital for the executor to be able to correctly handle these assets. Everyone with digital assets would greatly assist their families and executors by preparing an inventory of digital assets and their related information to serve as a roadmap to those assets. The helpful list of digital assets and accounts would include for each such asset or account: the physical location, digital location, information contained, user name, password, beneficiary (if any) and any helpful instructions.

Where should it be kept? One alternative is to keep a hard copy with the will (obviously not in it) or with other important papers. Another alternative is to leave such a list on a commercial platform. An industry has developed to help people handle their digital assets. Services such as Legacy Locker, AssetLock, Dead Man's Switch, Entrustet or others will store a digital inventory and will take pre-agreed actions at the owner's death.

Jim Lamm suggests doing a digital fire drill. Specifically ask the client to think about appropriate steps concerning his digital life if his computer were stolen, if he became incompetent, and if he died.

d. *Accessing and Managing Digital Assets.* While an individual may own the right to her own content, she may merely have a license to use the platform, and licenses often expire at death so transferability of the content may be problematic. Some accounts may even be deleted at death, creating an immediate nightmare for an executor.

When an individual creates a digital account, no one reads the contract information to determine what happens at the individual's death. For example, the Facebook contract provides that upon someone's death, the account may be "memorialized," or the account may be closed upon request from the person's next of kin. Yahoo permits family members to close the account, but not to access the account without a court order. (Which "family member" gets access? Is it first come, first served?)

If the fiduciary (or family members) do not know passwords, accessing digital accounts may be extremely difficult (if not impossible).

e. *Uniform Law Commission Project.* The Uniform Law Commission has a committee (the Fiduciary Access to Digital Assets Committee) that is addressing appropriate legislation that will vest fiduciaries with at least the authority to manage and distribute digital assets, copy or delete digital assets, and access digital assets.

f. *Disability*. Include the words "digital assets" in the power of attorney. It is unclear whether the host will recognize a power of attorney, but in the case of a dispute, at least the attorney can point to specific authorization in the power of attorney. It is likely that most digital contracts do not address incompetency.

g. *Will*. Three things should be considered in the will: who gets what digital assets, powers for the executor, and authority for the executor to hire help with digital assets.

The will could expressly provide for digital assets, separate from other tangible personal property. For example, the will could leave the computer to one child, but provide that all children get copies of family photographs. Another possibility is to leave a list outside the will (which may or may not be legally binding depending upon state law, but at least it expresses intentions to the family).

Broad-based powers of executors under state law theoretically are broad enough to deal with digital assets. However, adding the words "digital assets" in the executor's powers in the will may facilitate convincing the host to recognize the executor's authority.

Provide specifically that the executor can hire help to access and deal with digital assets. State law powers probably give that authority, but an express power may avoid confusion.

h. *Revocable Trusts.* Service providers may be reluctant to deal with an executor; they may be even more confused about dealing with a trustee after someone has died.

i. *Consent Form.* Attorneys should routinely discuss digital consent forms with clients. Having consent is at least a starting point in being able to deal with digital account providers. Jim Lamm (Minneapolis, Minnesota) offers the following form:

Authorization and Consent for Release of Electronically Stored Information

I hereby authorize any person or entity that possesses, custodies, or controls any electronically stored information of mine or that provides to me an electronic communication service or remote computing service, whether public or private, to divulge to my then-acting fiduciaries at any time: (1) any electronically stored information of mine; (2) the contents of any communication that is in electronic storage by that service or that is carried or maintained on that service; (3) any record or other information pertaining to me with respect to that service. The terms used in this authorization are to be construed as broadly as possible, and the term "fiduciaries" includes an attorney-in-fact acting under a power of attorney document signed by me, a guardian or conservator appointed for me, a trustee of my revocable trust, and a personal representative (executor) of my estate.

This authorization is to be construed to be my lawful consent under the Electronic Communications Privacy Act of 1986, as amended; the Computer Fraud and Abuse Act of 1986, as amended; and any other applicable federal or state data privacy law or criminal law. This authorization is effective immediately. Unless this authorization is revoked by me in writing while I am competent, this authorization continues to be effective during any period that I am incapacitated and continues to be effective after my death.

Unless a person or entity has received actual notice that this authorization has been validly revoked by me, that person or entity receiving this authorization may act in reliance on the assumption that it is valid and unrevoked, and that person or entity is released and held harmless by me, my heirs, legal representatives, successors, and assigns from any loss suffered or liability incurred for acting according to this authorization. A person or entity may accept a copy or facsimile of this original authorization as though it were an original document.

Signed _______________, 2013 ________________________________

j. *Digital Property Provision for a Will.* Jim Lamm also provides this "powers" will form provision.

Powers and authorizations regarding digital property. The personal representative may exercise all powers that an absolute owner would have and any other powers appropriate to achieve the proper investment, management, and distribution of: (1) any kind of computing device of mine; (2) any kind of data to storage device or medium of mine; (3) any electronically stored information of mine; (4) any user account of mine; and (5) any domain name of mine. The personal representative may obtain copies of any electronically stored information of mine from any person or entity that possesses, custodies, or controls that information. I hereby authorize any person or entity that possesses, custodies, or controls any electronically stored information of mine or that provides to me an electronic communication service or remote computing service, whether public or private, to divulge to the personal representative: (1) any electronically stored information of mine; (2) the contents of any communication that is in electronic storage by that service or that is carried or maintained on that service; (3) any record or other information pertaining to me with respect to that service. This authorization is to be construed to be my lawful consent under the Electronic Communications Privacy Act of 1986, as amended; the Computer Fraud and Abuse Act of 1986, as amended; and any other applicable federal or state data privacy law or criminal law. The personal representative may employ any consultants or agents to advise or assist the personal representative in decrypting any encrypted electronically stored information of mine or in bypassing, resetting, or recovering any password or other kind of authentication or authorization, and I hereby authorize the personal representative to take any of these actions to access: (1) any kind of computing device of mine; (2) any kind of data storage device or medium of mine; (3) any electronically stored information of mine; and (4) any user account of mine. The terms used in this paragraph are to be construed as broadly as possible, and the term "user account" includes without limitation an established relationship between a user and a computing device or between a user and a provider of Internet or other network access, electronic communication services, or remote computing services, whether public or private.

37. Estate Planning Considerations for Assisted Reproductive Technologies

a. *Significance*. According to the Center for Disease Control and Prevention, over 1% of all infants today are born as a result of assisted reproductive technologies, and that percentage is growing. Without asking, the planner never knows whether a particular client was born as a result or has descendants who were or will be born as a result of assisted reproductive technologies (ART). This includes insemination, in vitro fertilization, as well as other medical procedures. Without appropriate provisions in estate planning documents, surprising unintended results could occur.

Bruce Stone (Miami Florida) provides the forms addressed below. Bruce's outstanding and very readable drafting style is quite evident in these forms. Bruce points out that he raises these issues with all clients, and almost all of them want to include the provisions – even those who express a desire for extreme simplicity in the documents.

These issues can have very long lasting effects. For example, suppose a grandchild born 20 years from now has a child from a same-sex partner conceived through ART 50 years from now? How the instrument is drafted today can impact how those future descendants are treated as beneficiaries.

Parties can draft into their estate planning documents how they want ART descendants to be treated as beneficiaries under their documents. Provisions drafted into the estate planning documents only impact rights under those documents, not other legal rights of the parties.

b. *Central Theme: Who Is Family?* A central theme of addressing how a particular client wants to approach assisted reproductive technologies is the issue of what the client considers "family." For example, beyond just assisted reproductive technologies, why does anyone want to provide for great great great grandchildren who the clients will never know? This goes to the issue of "who is family?"

Focus on the *client's* intention about family, and the client's values and biases. The choices are not based on morality or law as it exists today. They are irrelevant in drafting ART provisions for clients.

c. *Adoption*. Most estate planning documents drafted currently deal with adoption. Clause 1.1 provides that the age of the adopted person determines whether he or she is treated as a child of the adopting parent.

d. *Child of Genetic Birth Mother*. Clause 1.2 provides that a person will be treated as the child of the woman who is both the genetic and birth mother of that person, whether or not conceived through ART, unless the woman's parental status is terminated by adoption.

An optional provision also provides an exception if the genetic birth mother is a surrogate mother who does not intend to function as a parent after birth and who has a surrogate agreement with the intended parents. (For example, if the client's granddaughter agrees to serve as a surrogate mother and has sex with the male of the couple who will be the intended parents, the baby will not be treated as one of the clients descendants.)

e. *Genetic Father of Child Conceived by Copulation.* Clause 1.3 addresses when a child who was conceived by copulation is treated as the child of the genetic father. A person who is the genetic child of two parents who are married to each other (or in a similar relationship such as a civil union) either when that person was conceived or at any time after conception is conclusively the child of the genetic father. This assumes that the conception resulted from copulation of the genetic father with the genetic mother. (If the genetic father by copulation is not in a marriage or similar relationship, clause 1.7 [discussed below] will control.)

f. *Conception Other Than By Copulation.* Clause 1.4 addresses a child conceived by means other than copulation of the genetic parents (i.e., by ART), using genetic material provided by the genetic parents with the intent to become a parent, which intent is acknowledged in a written instrument that is not revoked prior to the embryo being placed in gestation. It applies regardless whether the genetic parents are married to each other. As an example, it applies even if the resulting embryo is implanted into a surrogate mother. This clause only covers situations in which the child was placed in gestation during the genetic parent's lifetime. (Clause 1.9, discussed below, addresses a child not placed in gestation during the genetic parent's lifetime.)

Under this clause, the test of intention (with an acknowledged written instrument) is applied separately for each parent. Therefore, the child could be treated as the child of one genetic parent but not the other, even if they are married. This clause provides a default assumption that and incapacity causes revocation of the consent. The clause does not specifically address divorce and whether it revokes consent.

g. *Marriage (or Other Legal Relationship) Where One Spouse or Party Is Not a Genetic Parent.* Clause 1.6 provides that if only one party in a marriage (or similar legal relationship) is a genetic parent, the other party will be treated as a parent of the child if he or she evidences an intention to be treated as the parent, without the necessity of going through a formal adoption proceeding. (As an example, this may be helpful in same-sex marriages where one of the spouses will not be a genetic parent [at least under current technologies].)

h. *Intended Parent Under Agreement With Birth Mother*. Clause 1.6 would be relevant if the optional provision in clause 1.2 is used (providing that a surrogate mother is not treated as the mother of the child). Clause 1.6 says that the child will be treated as the child of the intended parents (or parent).

i. *Father Not in Legal Relationship With Genetic Mother and Prior Written Intent To Become Parent*. Estate planning documents typically have an "illegitimates" clause. Clause 1.7 is such a clause. It provides that a child who is not treated as the child of the genetic father under any of the preceding clauses will be treated as a child of the genetic father only if (i) he acknowledged parentage in writing, (ii) openly raised the person as his child, or (iii) was adjudicated to be the child's father.

j. *Child in Gestation on Parent's Death*. Clause 1.8 is similar to standard clauses in instruments providing that a child in gestation but born after the death of the parent will be treated as a being alive at the parent's death. (Some documents and legal authorities deal with the situation in terms of whether a child is *conceived* before a person's death. However, the key is gestation because under ART, a child can be conceived years before a parent's death.)

k. *Child Not in Gestation During Parent's Lifetime*. Clause 1.9 says that if a child is not in gestation on the death of a parent, the person will not be treated as a child of that genetic parent. In effect, if this clause is used, the estate planning document does not provide for posthumous children.

l. *Children Placed in Gestation After Genetic Parent*'s *Death*. If the client wants to include posthumous children, the terms will be considerably more complex. Bruce has optional complex forms in his materials dealing with posthumous children.

m. *Forms*. The following form clauses were drafted by Bruce Stone, and they are included with Bruce's permission. Interestingly, Bruce's documents also have explanatory comments (which are not included below) before each clause. He typically sends drafts of documents with the explanatory comments included for clients' review, and then removes the explanatory comments in the final document for signature. (He has some had some clients who have requested that the explanatory comments be left in the document.)

Rules Governing Family Relationships and Eligibility for Distributions

1. The descendants of a person who are eligible to receive distributions from any trust created under this instrument include only persons who are treated as descendants of that person under the rules set forth in clauses 1.1 through 1.9. Someone who is adopted or who is a genetic descendant of that person but who does not meet the conditions or requirements set forth in clauses 1.1 through 1.9 will not be a beneficiary of any trust created under this instrument.

Adopted Children

1.1 An adopted child will be regarded as a descendant of the adopting parent if the petition for adoption was filed with the court before the child's eighteenth birthday, and the descendants of that child will be regarded as descendants of the adopting parent. An adopted child will not be regarded as a descendant of the adopting parent if the petition for adoption was filed on or after the child's eighteenth birthday. If a court terminates the legal relationship between the parent and child while the parent is alive, that child and that child's descendants will not be regarded as descendants of that parent. If a parent dies and the legal relationship with the parent's child has not been terminated before the parent's death, the child and the child's descendants will still be regarded as descendants of the deceased parent even if another person later adopt the child.

Child of Birth Mother

1.2 A woman who is both the genetic and birth mother of a person will be treated as a parent of that person, whether the person was conceived by copulation or by means other than copulation, unless the woman's parental status was terminated by adoption [***optional provision:*** , subject to the following. A woman who, without any intent to function as a parent following birth, carried a person to birth under an agreement with that person's intended parents or parent will not be treated as that person's mother, and that person will not be treated as the child of that woman, whether or not the woman is a genetic parent of that person].

Genetic Father in Marriage or Substantially Similar Legal Relationship with Genetic Mother

1.3 If a person was conceived by copulation of the genetic parents, the person will be treated as the child of the genetic father if the genetic parents were parties to a marriage, civil union, domestic partnership, or substantially similar legal relationship with each other when the person was conceived or at any time after conception.

Conception Other Than By Copulation

1.4 If a person was conceived by means other than copulation, the person will be treated as the child of a genetic parent only if that parent provided his or her genetic material with the intent to become a parent acknowledged in a written instrument signed by that genetic parent which was not revoked by a subsequently dated written instrument signed by the genetic parent before gestation began. A genetic parent's intent to become a parent will be deemed conclusively to have been revoked if a court determined that genetic parent to be legally incapacitated and the court did not restore that genetic parent's legal capacity before gestation began, or if that genetic parent is missing (as defined in other provisions of this instrument), unless the acknowledged written instrument signed by that genetic parent expressly states that the intent to become a parent will not be revoked by the genetic parent's legal incapacity or if that genetic parent is missing. The provisions of this clause do not apply to a woman who is both the genetic and birth mother of that person.

Marriage or Substantially Similar Legal Relationship Where One Spouse or Party Is Not a Genetic Parent

1.5 If a person is treated under clause 1.4 as the child of a genetic parent, and if when the child was conceived that genetic parent was a party to a marriage, civil union, domestic partnership, or substantially similar legal relationship with someone who is not a genetic parent of the child, the child will be treated as the child of the other party to the marriage, civil union, domestic partnership, or substantially similar legal relationship if the other party acknowledged intent to become a parent in a written instrument signed by the other party which was not revoked by a subsequently dated written instrument signed by the other party before the child was in gestation.

*Intended Parent Under Agreement With Birth Mother [**optional provision**]*

1.6 A person will be treated as the child of another person who was not married to (or in a civil union, domestic partnership, or substantially similar legal relationship with) the birth mother of that person and who intended to be a parent of that person (whether or not the intended parent is a genetic parent of that person) under an agreement with the birth mother that was not revoked before the child was in gestation, whether or not the agreement is legally enforceable.

Father Not in Legal Relationship With Genetic Mother and With Prior Written Intent To Become a Parent

1.7. If genetic testing establishes that a person is the child of the genetic father but that person is not treated as the child of the genetic father under any of the preceding clauses, that person will be treated as the child of the genetic father only if:

1.7(a) the genetic father acknowledged parentage of the person at any time after conception in a written instrument signed by the genetic father;

1.7(b) the genetic father openly raised and acknowledged the person as his child; or

1.7(c) parentage was established by adjudication.

Child in Gestation on Parent's Death

1.8 A child who was in gestation on the death of a person treated as a parent of that child under any one of clauses 1.1 through 1.7 and who is born alive after the death of that person will be treated as living on that person's date of death.

Child Not in Gestation During Parent's Lifetime

1.9 A child born after the death of a person who would otherwise be treated as a parent of that child under any one of clauses 1.1 through 1.7 will not be treated as that person's child if that child was not in gestation on that person's date of death.

38. Elder Law Planning Issues

a. *Significance of Elder Law Planning*. More than 10,000 people turn age 65 every day. By 2030, one in five Americans will be over age 65. Persons reaching age 65 have an average life expectancy of an additional 16-20 years; highly educated/high income individuals typically live even longer.

Less Family Support. Elder individuals receive less family support than in prior eras.

Government Programs. Elder people stop working and must find income replacements. They typically turn to government programs – Social Security, Medicare, and Medicaid. There is a good chance that individuals will receive more benefits from government programs if they have an attorney advising them.

Dementia. Dementia is a significant elder law issue. Estimates are that almost half of Americans age 85 and older have dementia. Past age 90, a clear majority of people have dementia. A focus of elder law is to arrange plans so that clients can navigate their world with diminished capacity.

Legacy. The desire to preserve some legacy for children intensifies the need for advice on getting to death and still preserving some assets.

Health Care Costs. Increasing health and long-term care costs create a real danger of depleting the estate or leaving the elder person unable to afford to live in a dignified and comfortable manner. About 70% of Americans will need some kind of long-term care.

Quality of Life. The key focus of elder law planning is providing quality of life in the last 25-30 years of one's life. People want to remain independent as long as possible with the highest quality of life and in the least restrictive environment.

100% Tax. An almost universal perception of older clients is that Medicare will pay for their long-term care. However, Medicare only pays for skilled nursing and healthcare, not custodial care. In practice, most of the funding for long-term custodial care comes from Medicaid, but an individual must become impoverished before qualifying for Medicaid. In effect, "the elder care tax has a 100% rate."

Practical Impact. The typical elder law client might have about $200,000-$400,000. Nursing home costs on the average are $80,000-$120,000 per year. Finding that entire life savings will be required to provide care for just 1-2 years is devastating. "Clients just want a fair stake. Clients are willing to pay something for healthcare but do not want to become impoverished. They go to lawyers and see how to qualify for government programs not really meant for them, or they go broke and then qualify for the government program anyway."

Understand Client's Perspective: Fear. The 11th commandment is "thou shalt not spend principal." As a person's income decreases it becomes impossible to honor that commitment. Always keep in mind the perspective of clients who are getting older; the ***fear*** they will outlive their money is enormous.

Few Have Done Planning. Despite the critical nature of these issues, about 80% of elder planning clients are crisis clients who have done no planning.

b. *Elder Law Goals and Values*. Elder law planning is a holistic approach to provide the following:

- Preserve client's autonomy with effective financial planning for 30+ years
- Focus on quality of life (including decent housing)
- Plan for and promote adequate acute and long-term health care
- Create surrogate decision-making plans in the event of a loss of mental capacity
- Preserve the value of the estate to the extent possible.

c. *Fee Sensitivity*. Relatives reap the benefits of estate planning, but elder law clients are staring at immediate bills. If the attorney can do something to reduce those payments, the client is very willing to pay for advice – often more willing than for estate planning. Jonathan Blattmachr relayed that an elder law attorney told him, from experience, that as a practical matter individuals' assets will be eaten up in 3-4 years of long-term health coverage before they qualify for Medicaid benefits. Once the clients realize that any money paid in legal fees would otherwise go to the state or health care providers, there is no resistance in billing.

d. *Income During Retirement: Overview*. There are three sources of income for older persons – Social Security, qualified retirement plans, and savings.

e. *Social Security*.

(1) *Key Ages*. Key ages are 62, 66 and 67.

At age 62, individuals can begin receiving Social Security but must quit work to do so, and they take a permanent reduction in benefits.

At age 66, an individual can receive benefits without retiring. Benefits are based on the highest 35 years of earned income (up to a maximum amount each year) in years the individual participated in the Social Security program. If an individual has always earned the maximum for 35 years, Social Security benefits will be about $30,000 per year at age 66. If both spouses have worked, they would get about $60,000 per year. The vast majority of people choose to begin receiving Social Security benefits at age 66.

At age 70, the maximum benefit is reached. If an individual defers receiving benefits, the benefits go up 8% per year, so from age 66 to age 70, the benefit would increase by 32% to about $40,000 per year. It takes about 12½ years to recover the four lost years of benefits--14 years taking into account the time value of money. Therefore, the decision to defer benefits means that at age 70, the individual thinks he or she will live to age 84.

(2) *Rights of Spouses*. If married to a person of the opposite sex, the individual can receive benefits based on his or her own work record or 50% of the spouse's benefits, whichever is higher. Divorced spouses have rights to benefits that decreases neither the employee-former spouse's benefits nor those of the employee's present spouse.

The following is an optimal approach often used by two-income spouses. Assuming husband turns 66. He files for benefits which would entitle him to receive $30,000 per year, but he "suspends" receiving benefits (to take advantage of the 8% per year increase in benefits if receipt is deferred). When wife turns age 66, she can claim under her own work benefits or the spousal benefit. She elects to claim the spousal benefit, or 50% of what husband was eligible to receive at age 66 (i.e., about $15,000). At age 70, husband and wife each claim their own benefits ($40,000 for each of them). Wife gave up four years of benefits, but she only gave up $15,000, not $30,000 per year. With this approach, wife only needs to survive 8-9 years after reaching age 66 to come out ahead by deferring the receipt of her own benefits to age 70.

(3) *Qualified Retirement Plans*. When an individual retires, the 401(k) plan is typically rolled over to an IRA. The individual will make investment management decisions regarding the IRA, and individuals need advice about how the IRA will be managed if they become demented—suggest having at least some of the funds in passive assets such as index funds or mutual funds.

(4) *Savings; Annuity*. A rule of thumb is that about 4% per year can be withdrawn from savings without impacting the present value. Therefore, only about $40,000 per year would come from $1 million of savings, without impacting the principal amount.

An alternative that many should explore is to convert some of the savings to an annuity. For example, an individual with $2 million in savings might invest $200,000 of that in an annuity. (i) That leaves investment management decisions with the annuity provider. Do you really think your older client will invest better than Prudential? (ii) The client is assured of receiving a certain monthly income for life, from the annuity and Social Security. The annuity is an approach to preserve a certain amount of money.

Consider whether to fund a trust for management purposes to manage the savings in case the client suffers mental incapacity.

f. *Medicare.* Medicare is a federally subsidized health insurance program, enacted in 1963 as part of the Great Society of President Johnson.

An individual first qualifies for Medicare at age 65 (there are several exceptions allowing benefits at an earlier age). At that point, the individual should go online and apply for Medicare, even if not claiming benefits. An excellent summary of Medicare (the "official U.S. government Medicare handbook") is available at http://www.medicare.gov/Pubs/pdf/10050.pdf. The Center for Medicare Advocacy is another excellent resource of information about Medicare. The information described below about Medicare is publicly available, and older individuals will find this information on the Internet. However, if the attorney does not know these facts, the individual will not trust the attorney about other elder law issues.

Medicare has four parts. Part A pays for hospitals; this is funded by the Medicare tax on wages (most recently 2.9%, going up in 2013 to 3.8% for individuals earning over a $250,000/$200,000 threshold) and the 3.8% tax on net investment income beginning in 2013 for individuals earning over that same threshold amount. (When people say Medicare will go bankrupt they are talking about Part A. But realize that people were saying the same thing 15 years ago.)

Part B pays for doctors, funded by general tax revenues. There is a monthly premium of about $90-$100 per month, which is supposed to pay for about 25% of the cost of Part B.

Part C is called Medicare Advantage. An individual can elect to join a Medicare Advantage Plan in his locality. It operates like an HMO-the provider agrees to pay all healthcare costs. The Medicare Advantage Plan pays all Part A, B, and D coverage. (Political campaigns have talked about $500 billion being cut from Medicare. The Affordable Care Act reduces payments to a Advantage Plans if an individual opts to use Medicare Advantage.) Make sure that the plan provides needed services if the individual travels.

Part D is a prescription drug plan. If not covered by other medical insurance, persons reaching age 65 should enroll in a Part D drug plan, which is heavily subsidized by the government so that the individual is not paying market rates. Individuals must choose among plans, to match their particular drug needs. Prices vary significantly among plans, and the premium increases for higher income individuals. Part D plans have four stages of payment (2013 figures). (i) Initial deductible of $325. (ii) Plan pays 75% of prescriptions up to $2,970. (iii) More limited coverage from $2,970 up to $4,750 – the coverage gap or "doughnut hole." In 2013, in the coverage gap the enrollee pays 47.5% of the cost of brand name drugs and 79% of the cost of generic drugs. This is gradually reduced until 2020, when payments will not exceed 25% for any drug in the gap. (iv) Plan pays 95% of all costs above $4,750.

g. *Supplemental Medicare Policies.* These are commonly referred to as Medigap policies. Part A pays only a limited number of days, and Part B has a 20% co-pay. There are eight different kinds of supplemental plans, labeled A-J. Every A plan is identical, every B plan is identical, etc. Shop around plans, because the same benefits are available regardless of the provider. Generally, buy the cheapest plan in the class that is needed.

h. *Paying for Long-Term Care.*

(1) *Nursing Home.* Medicare pays for skilled nursing care, not custodial care. An individual must have a three-day hospital stay before going to the nursing home, and must move to the nursing home within 30 days of being in the hospital in order for Medicare to pay anything. Medicare will pay skilled nursing care for 20 days in full. For days 20-100 there is a copayment ($148 per day in 2013), which is paid by most Medigap policies. After 100 days, Medicare pays nothing for nursing home care. Persons with a chronic illness can be in a nursing home for years. Under federal law, the patient's spouse is legally responsible to pay this expense.

(2) *Sources to Pay for Long-Term Care.*

- Out-of-pocket. (The planner can assist in advising what personal sources should be used first. For example, the funds could come out of an IRA, which would be taxable income, but the individual may get a significant offsetting medical care income tax deduction.)
- Medicare, but it only pays for 100 days of skilled nursing care.
- VA benefits. Sometimes a VA facility must be used, but not always.
- Long-term care insurance – only about 7% of long-term care expenses in the U.S. are paid by long-term care insurance. Less than half of the major companies that used to sell long-term care insurance still do. Long-term care costs have been higher than anticipated, and the companies are finding that the policies are not profitable. There is a sea change going on in the long-term care insurance industry. Some persons who purchased long-term care policies in the mid-1990s have had their premiums increased substantially. As a result, most people have stopped purchasing these policies. There are now hybrid long-term care policies that are combined with annuities or life insurance. For a further discussion of long-term care insurance, see Lawrence Frolik, *Long Term Care Insurance: Deal or No Deal?,* 43 UNIV. MIAMI HECKERLING INST. ON EST. PL. ch. 17 (2009).
- Medicaid. Medicaid pays about half of all nursing home costs. There is a stigma attached – that Medicaid is for poor people. However, it has been the "safety net" for the middle class. It pays not only nursing homes but home care, hospitals, doctors, etc.

(3) *Medicaid.* Medicaid pays at a lower rate than the "private pay rate." To qualify, an unmarried individual must essentially spend all his resources and devote all his income to the cost of care. Medicaid will pay the resulting shortfall. A married applicant must spend all of his income for his care, but the spouse's income (up to a limit) is not counted and that income is not considered available for the support of the institutionalized spouse.

- *Income Cap.* In "income cap" states (there are only 13 of them), the applicant's income cannot exceed 300% of the monthly Supplemental Security Income (SSI) which is $710 in 2013. The income cap is 300% of that, or $2,310. In most states, there is no income limit to disqualify any individual from Medicaid, but income must be used to pay expenses. ("Miller trusts" can be used as a planning alternative in "income cap" states.)

- *Resource Limit*. Generally the individual must have less than $2,000 of non-exempt assets to qualify for Medicaid. (This varies among states; New York has the highest level of about $14,000.) There are some exempt assets including (i) a family home as long as the applicant or the applicant's spouse lives in the home (there is a maximum equity value limit, up to $802,000) and (ii) retirement accounts (in some states) that are in "payout" status (as long as the minimum required distribution is being withdrawn each year). (Some states have estate recovery programs that permit the state to recover health care costs out of proceeds of the house sale or out of retirement benefits.)
  There are also income and resource limitations on the "community" of a married couple that apply in addition to the general $2,000 limit on resources of the person applying for Medicaid. These are discussed below regarding Spousal Liability and Planning With Spousal Transfers.

  Converting resources to an asset that merely produce an income stream is one way that may satisfy the resources limit. Strategies that will work vary from state to state. Using resources to buy annuities may work in some states or lending money to a child for a note may work in other states to avoid the resource limit. The income that is paid to the applicant will have to be paid to the nursing home, but there is a possibility that some payments after the applicant's death could pass to family members.

- *Look-back Period*. Gifts made within a look-back period cause ineligibility for Medicaid. The look-back period was initially 24 months, then increased to 30 months, and later increased to 36 months for individuals and 60 months for trusts. (The thinking behind the longer look back period for trusts was that if an individual could afford a lawyer to prepare trust, the individual should wait longer.) Several years ago, the look-back period was changed to be five years for transfers to either individuals or trusts. The look-back period could be increasing; there was a proposal last year to increase it to 10 years.
  All gifts made within the five-year look-back period are presumed to be for purposes of qualifying for Medicaid. It is possible to try to rebut the presumption but difficult to do so. (The successful cases are ones where the applicant can show he or she was in good health at the time of the gift and able to pay bills after making the gift.)

  Effect. If a gift is made within the five-year period, there is a penalty period during which Medicaid will not cover expenses. The penalty period does not even start until the person is physically in the nursing home and has less than $2,000 and makes application for Medicaid. The aggregate of gifts made within the prior five years is divided by the average cost of nursing home care in that state (or in the community). For example, if the average cost of care is $7,000 and gifts within the five-year period were $70,000, the person is ineligible for 10 months.

- *Who Pays During Penalty Period*? A key planning issue is determining who will pay for nursing home costs while the penalty period is running. One alternative is converting some of the assets to annuities or notes and using the income from them to pay those costs (as discussed in the paragraph above regarding the Resource Limit.) Another alternative that will work in some states is to use an Irrevocable Income Only Trust, described below.

- *Irrevocable Income Only Trust.* The Irrevocable Income Only Trust (IIOT) is an alternative that may assist the family in not having the total family wealth wiped out by long-term care costs. Generally speaking, the IIOT is an irrevocable trust providing that the trustee will distribute income to the Settlor or the Settlor's spouse. This income will be available for Medicaid purposes in the month in which it was received. (It is best to provide that the income will be distributed to the "better health" spouse first. Amounts paid to the well spouse may not be within the reach of Medicaid for nursing home costs of the other spouse.) Trust principal may not under any circumstances be distributed to the Settlor or the Settlor's spouse. Trust principal could not be reached by Medicaid, although it may be subject to "estate recovery" provisions following the death of the Settlor depending on the state involved. The IIOT is merely exempt from disqualifying the individual from receiving Medicaid benefits in the first place.

  Medicaid applies a five-year look-back rule for any transfers to determine if an individual qualifies for Medicaid. Accordingly, "this planning is not for people in crisis mode. It's for people who want to think ahead, and are willing to give up some control of their money before they are actually in crisis mode."

  The general goal would be to transfer some assets to the IIOT that would be protected after the individual moves to a nursing home, but to retain assets to provide for living expenses of the individual for at least five years (or longer if the individual does not anticipate needing a nursing home for a longer period). Ideally, the pot of retained assets would be less than $2,000 at the time that the individual needs nursing home care.

  For a detailed description of the IIOT strategy, see Item 18 of the 2012 Heckerling Musings at http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/01_2012_Heckerling%2520Summary.html

- *Caretaker Child or Sibling.* An individual may transfer a residence to a child or sibling who has lived with the individual in the house as a caretaker for a minimum period of time. These caretaker transfers would not be treated as prohibited transfers within the five-year look-back period.

i. *Spousal Liability; Planning With Spousal Transfers*. Married people are legally responsible to pay for the health care of their spouses. The Federal Human Health Services Agency of the federal government has announced that it will not enforce DOMA for Medicaid Purposes. Therefore, same-sex couples may be subject to this legal obligation as well for Medicaid purposes, but same-sex couples generally are not responsible.

Spouses are liable regardless how long the person has been married. There are increasing numbers of marriages of older people; this liability is an important factor that should be considered in case one of the spouses should become institutionalized. (Pre-marital agreements do not help to avoid that liability to pay nursing home costs.)

In some states, a divorce may help protect some of the spousal benefits.

Inter-spousal transfers are *not* subject to the five-year look-back period. However, inter-spousal transfer planning must take into account additional limits on the resources and income of the "community" of a married couple to qualify for Medicaid.

- *Community Spouse Resource Allowance.* Under the Medicaid rules, there is not only a limitation on resources owned by the applicant (generally $2,000), but there is also a limit on the "community resources" of the married couple. There is a "community spouse resource allowance" that can be up to $115,920 in 2013 (this is an indexed number that increases every year), but some states have a substantially lower community exemption amount.
- *Community Spouse "Minimum Monthly Maintenance Needs Allowance"*. There is also a maximum allowed community income that is allowed to qualify for Medicaid, which is up to a maximum of $2,898 per month (this is lower in some states).

For example, if Husband owns $250,000 and is going to a nursing home, Husband may transfer the $250,000 to Wife. (If Husband is not competent, hopefully there is a revocable trust or power of attorney that would permit this transfer.) At that point, Husband would qualify for Medicaid, but the Wife is legally responsible to pay for his health care. Assume Wife has that $250,000 and the community exemption is $115,000. She has $130,000 over the limit, and Wife could buy an annuity for that $130,000. (The annuity must be an actuarially sound annuity.) The state must be the remainder beneficiary of the annuity. So the annuity is typically purchased as a short annuity — perhaps a two year annuity. Wife's $115,000 plus the income stream would not disqualify Husband to receive Medicaid benefits.

j. *Joint Accounts*. Medicaid assumes that all assets in a joint account belong to the person applying for Medicaid benefits, except to the extent that the joint owner can prove that he or she made contributions to the account. If there is a brokerage account requiring two signatures for withdrawals, the joint owner can remove one-half of the account.

Transfers into a joint account within the five-year look-back period cause the penalty period to apply. The joint account rules, which can exempt part of the account, apply only for accounts that have been created five years before application for Medicaid benefits.

39. Decanting

a. *General Description.* If a fiduciary can invade principal, the trustee may be able to "decant" (meaning "to pour from one container to another"), moving the assets from the existing trust to another trust for the beneficiary. *Phipps v. Palm Beach Tr. Co.,* 142 Fla. 782, 196 So. 299 (1940), decided as a matter of Florida common law that a trustee has the power to distribute to a trust rather than outright to a beneficiary.

A number of states have decanting statutes, and various states are considering decanting legislation. The statutes vary significantly.

b. *Significance; Example Decanting Situations.* Decanting may be helpful in a variety of situations, such as the following:

- To provide tax protection for trust purposes; for example, to eliminate the insured as a trustee to avoid estate inclusion under §2042;
- To give a beneficiary a power of appointment when a disposition different than the default beneficiary under the existing trust is desired; the trust could say that the

beneficiary could exercise the power only with the consent of a non-adverse party to prevent a completed gift and to prevent an unwise exercise;

- To reduce administrative costs (for example, by merging trusts);
- To change fiduciaries or the manner in which fiduciaries are appointed; for example, beneficiaries could be given removal powers that comply with Rev. Rul. 95-58 by analogy;
- To extend the termination date of the trust; decant to allow the trust to last as long as local law permits;
- To convert a grantor trust to a non-grantor trust or vice-versa;
- To change the administrative or governing law of a trust;
- To divide a trust into separate trusts; for example splitting a sprinkling trust for multiple beneficiaries into separate equal trusts for the respective beneficiaries;
- To reduce potential liability; for example transferring environmentally tainted assets to a separate special trust with limited trustee liability;
- To convert a trust into a supplemental needs trust; three separate cases in New York have allowed that; this is done very commonly;
- To make a non-spendthrift trust a spendthrift trust, or vice versa;
- To make changes in light of changed family circumstances;
- To convert to a directed trust to permit desired investments; and
- To correct drafting errors without having to go to court.

Observe that even though these are situations in which decanting may be helpful (and indeed are often being used), there may be tax consequences (for example, destroying the GST exempt nature of a trust) to decanting in these situations. See the discussion below.

c. *No Ruling Position.* Rev. Proc. 2011-3, 2011-1 I.R.B. 111 (the annual "no ruling" revenue procedure) added "decanting" rulings to the list of topics under Section 5, dealing with areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise. Sections 5.10 and 5.17 of Rev. Proc. 2012-3, 2012-1 IRB 113 continue that approach.

d. *Notice 2011-10 and Further IRS Guidance.* Notice 2011-101 requests comments on various issues regarding decanting, and the IRS received a number of comments. The Priority Guidance Plan for 2012-2013 dropped the decanting project, raising the issue of whether the IRS is actively working on the project this year, and suggesting that further guidance might not be coming for some extended time (if ever).

e. *Should Planners Continue Decanting Transactions?* Whether to proceed with a decanting transaction at this point depends upon the differences in the trust terms. If mere administrative provisions are being changed, that should not cause a problem, even though it is not possible to get a ruling. If the decanting transaction affects distributions or extends the duration of the trust, various adverse tax consequences are possible, and planners should be wary. Some commentators suggest that it might be better to act sooner rather than later, because any IRS guidance may be negative, and would likely be prospective only.

f. *Discussion of Tax Effects.* For a further discussion of the possible tax effects of decanting, see Item 7 of the summary at

http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/12_2012_Estate%2520Planning%2520Current%2520Developments.html

40. Pre and Post Nuptial Agreements

a. *Difficult Agreements.* Negotiating premarital agreements is not fun because one of the parties usually does not want it. In essence, the parties are pre-negotiating the terms of a future divorce that may never happen. In addition, these agreements often happen near the wedding and puts a damper on the cheeriness of the wedding proceedings (As discussed below, agreements must be voluntary and raising the agreement for the first time too close to the wedding [for example, after the wedding invitations have been sent] may raise questions about whether the agreement signed under duress and was not voluntary.)

b. *Consider State Law Variances.* One of the reasons that premarital agreements are important is that the laws governing marital rights vary from state to state. The agreement can lay out the intent of the parties even if they subsequently move to a different state having different move marital rights laws. Furthermore, state law can change even if the couple does not move.

c. *Enforceability; Uniform Acts.* There is considerable disagreement as to the enforceability of pre-marital and post-marital agreements (post-marital agreements are sometimes referred to merely as "marital agreements").

The Uniform Premarital Agreement Act, promulgated in 1983, has been adopted in various forms by more than half the states. Nevertheless, there is not uniformity because many states that adopted it have made substantial changes, and the courts have interpreted the provisions differently from state to state.

The Uniform Premarital and Marital Agreement Act was promulgated on July 18, 2012. The purpose of the new uniform act is to bring greater consistency to the way in which the states enforce premarital agreements and agreements executed during marriage. The 2012 Uniform Act has various important changes from the 1983 Act.

d. *Fundamental Enforceability Requirements: Voluntary, Disclosure, Unconscionability.* Under the 1983 Uniform Act, a premarital agreement is not enforceable if the party proves that: (i) he or she did not execute the agreement voluntarily; or (ii) the agreement was unconscionable when executed and before execution of the agreement he or she was not provided a fair and reasonable disclosure of the property or financial obligations of the other party, did not voluntarily and expressly waive in writing such disclosure and did not have and reasonably could not have had an adequate knowledge of the property or financial obligations of the other party. Therefore, an agreement could be enforced as long as it was voluntary and there had been fair and reasonable disclosure of the property of financial obligations – *even if the agreement was unconscionable*. (The 1983 Act also provides a limited exception to enforceability, providing that a waiver of spousal support will not be effective if it causes the other party to qualify for public assistance.)

Under the 2012 Uniform Act, the agreement must satisfy *all* of the following requirements to be enforceable: (i) the agreement was voluntary and not the result of duress; (ii) the parties had access to independent legal representation; (iii) if a party did not have independent legal representation at the time the agreement was signed, the agreement included a notice of waiver of rights or an explanation in plain language of the marital rights or obligations being modified or waived by the agreement; and (iv) before signing the agreement the parties received adequate financial disclosure, except that a party could waive receiving financial disclosure. (The burden of proof is on the party seeking to avoid the agreement.) There is a limited exception, similar to that in the 1983 Act, for a waiver of support causing a party to qualify for public assistance.

- *Voluntariness*. The 2012 Act adds that the agreement was not signed under "duress;" query what gloss courts may add to this additional requirement?
- *Independent representation*. It is sufficient if the parties had a reasonable time to decide to hire, retain, and consider advice. If one party is represented by a lawyer, the other party has to have the financial ability to hire a lawyer as well, or the party who is represented must agree to pay for the other party's lawyer.
- *Waiver of rights*. If a party is not separately represented, there must be provision briefly describing rights that the party may be giving up by signing the agreement (the Act includes a sample waiver clause, but it permits using "substantially similar" language).
- *Adequate financial disclosure*. There must either be a reasonably accurate description of the value of property, amount of liabilities, income, etc. of the parties, or a waiver of the right to receive financial disclosure (and the waiver must be in a separate document signed by the parties, but unlike the representation waiver, the financial disclosure waiver does not have to give any instructions as to rights that the parties may be giving up).
- *Unconscionability*. Under the 2012 Uniform Act, a court has the discretion to refuse to enforce a term of a premarital or marital agreement if the term was unconscionable at the time of signing. This is a ***major departure*** from the provisions of the 1983 Act, which allowed enforceability of agreements, even if they were unconscionable, as long as full financial disclosure had been given. ***This may represent a significant trend in future laws regarding the enforceability of marital agreements.***

e. Best Practices.

(1) *Independent Counsel*. The parties should have independent counsel. If the other party lacks the resources to pay for counsel, your client should offer to pay.

(2) *Timing*. Raise the topic of having a premarital agreement several months before the wedding. Present a draft for review at least one month prior to the wedding.

(3) *Financial Disclosure*. The more the better. To avoid doubt as to income, exchange income tax returns.

(4) *Disadvantaged Spouse's Future Support*. If representing the disadvantaged spouse, make sure he or she will have enough resources for support in the future. For example, if one party is protecting a family business interest, there may be little marital property. The agreement could provide for deemed marital property based on the length of the marriage.

(5) *Home*. The ownership of the family home, especially for the disadvantaged party, may be extremely important. He or she may be willing to forfeit substantial economic rights to be able to keep the home.

(6) *Gifts*. If there have been substantial gifts during the marriage, disagreements may arise upon divorce as to who owns the property. To avoid those disputes, consider

including a clause that property purchased during marriage in excess of, say, $10,000 will be deemed to be the property of the person who purchased it with his or her own property.

(7) *Retirement Benefits*. ERISA provides that an agreement prior to marriage will not waive ERISA rights. The agreement should include a clause requiring the parties to execute a confirmation of the agreement after the wedding. Attach to the document the form that the parties agree to sign later.

(8) *Legal Fees*. Consider a provision that a party challenging the agreement must pay the attorney fees of the other party in the challenge action.

(9) *Confidentiality*. Consider including a confidentiality clause.

(10) *Prohibited Conduct*. Some agreements include provisions requiring the payment of a penalty upon the occurrence of certain prohibited conduct, such as unfaithfulness (purportedly this was in the Michael Douglas agreement).The Uniform Acts do not address whether these types of provisions are enforceable, and there is inconsistent case law.

(11) *Taxes*. The agreement should address income taxes that will be borne by each party with respect to his or her portion of the marital property.

41. Pre-Mortem Planning

a. *Obtain Copies, Review and Update Documents.*

(1) *Will* – consider re-executing the will to reaffirm wishes and to make sure witnesses are alive.
(2) *Revocable Trust* – fund it if appropriate.
(3) *Beneficiary Designation*s – are often not coordinated.
(4) *Powers of Attorney* – make sure it is durable; if the client will soon be disabled, do not make it a springing power; if a springing power is used, include physical impairments as well as just disability; consider ability to make gifts, listing limits and potential donees.
(5) *Powers of Appointment* – consider exercising, but observe that pre-1942 general powers of appointment are not included in the gross estate unless exercised.
(6) *Pre-Nups and Post-Nups* – now they really need to be reviewed because they can override the will provisions.
(7) *Buy Sell and Partnership Provisions* – they can also override will provisions and create conflicts.
(8) *Health Care Documents* – make sure they are valid in all states where the client might be located; executing new ones does not revoke old ones.
(9) *Guardianship Designations* – in particular address the designation of who should serve as guardian for the dying individual if needed.
(10) *Funeral and Burial Directions* – some states allow designating who can control burial arrangements; if not, make a bequest subject to the condition of making the desired burial arrangements.
(11) *HIPPA Releases.*

b. *Update Dispositive Provisions of Documents.*

(1) *Beneficiaries, Amounts, Ages*. Right people? Right amounts or percentages? Right ages?

(2) *Trusts*. Should a trust be used for creditor or divorce protection purposes? If so, review fiduciary dispositive standards.

(3) *Naming Fiduciaries*. This is what often keeps people from finalizing wills, but it must be done at this point. ("Are you going to have a friend be the trustee – who won't be a friend very much longer?")

(4) *Tax Apportionment*. Tax apportionment clauses are very important dispositive provisions. A "pay all taxes from the residue" clause can be dangerous if there are buy sell agreements; consider apportioning taxes to the recipients of the business interests governed by the buy sell agreement.

(5) *Tangible Assets*. Some states do not allow disposition of tangibles by a writing, but do it anyway. It resolves disputes and people tend to honor the decedent's wishes even if not legally binding.

c. *Family Tree*. Prepare a family tree so that the client's knowledge of the family will not be lost.

d. *Guard Against Probate Contest*.

(1) *Testamentary Substitutes*. Load up on testamentary substitutes. In some states, there is a lower standard of capacity for executing a trust than a will. The statute of limitations for a contest may be shorter for trusts.

(2) *Execution Ceremony*. Have the client explain to witnesses what is being done so they can testify that the client understood.

(3) *Multiple Wills*. If there is time, consider doing new wills every several months. Under the doctrine of dependent relative revocation, if the latest will is not valid, the prior one becomes operative. A contestant must then contest multiple wills.

e. *Review State Law Issues*. Consider whether there should be a change of domicile (which requires intent, so the client must be competent). Consider the effect of state law with respect to various issues.

f. *In Terrorem Clause*. States differ regarding the enforcement of in terrorem clauses. If the state is toothless in enforcing them, consider providing some bequest to the "problematic" beneficiary in the final will, but in the next to last will cut out that beneficiary. The beneficiary will know that if he or she successfully contests the final will, the next prior will becomes operative which cuts out the beneficiary.

g. *Review Assets and Titles*. Clients invariably are wrong in knowing how their assets are titled. Particularly consider whether survivorship accounts are coordinated with the estate plan.

h. *Particular Asset Considerations*.

(1) *Highly Appreciated Assets*. If the "well spouse" owns highly appreciated assets, consider transferring them to the "ill spouse" to get a stepped-up basis. If the donee dies within a year and the original donor inherits the property back, there will be no basis step up, §1014(e). If the donee-spouse does not live a year, include disclaimer planning so that the surviving spouse can disclaim the bequest into a bypass trust. A basis step up might then be available.

(2) *Life Insurance*.

- Other favorable conversion options?
- Can additional insurance be obtained without a medical exam?
- Repay outstanding policy loans to reduce the gross estate making it easier to satisfy the various 35% tests (if any of them are relevant).

(3) *Employee Benefits*. If employee benefits were in pay status in 1985, they still qualify for the $100,000 exemption from gross estate inclusion. If the benefits were in pay status in 1983, they are entirely excluded from the gross estate. (An individual who was age 65 and 1983 is now age 95; some of them are still around.)

(4) *Buy Depreciating Assets*. If the beneficiary will buy some "toy" (expensive auto, etc.) after the client dies, have the client buy the asset to leave to the beneficiary. The asset will have depreciated at the client's death, leaving a lower gross estate.

i. *Consider Gifts*.

(1) *High Basis Assets*. Give high basis assets.

(2) *Annual Exclusion Gifts*. Make annual exclusion gifts.

(3) *Checks*. The check must clear before death. Use a cashier's check or certified check (that is pre-cleared by the bank) and deliver the check before death (even if it is just being delivered to an attorney as agent for the donees).

(4) *Pre-fund Pecuniary Bequests*. Pre-fund pecuniary bequests that would otherwise be made under the will and make clear that the gift is in place of the bequest. The gift may be covered by annual exclusions; even if not, this may simplify the estate administration.

(5) *Minority Interests*. Give (or sell) discountable assets such as minority interests in businesses; perhaps give enough to get the client's retained interest below 50% as well.

(6) *Charitable Gifts*. Accelerate charitable gifts to get an income tax deduction.

(7) *Transfers to Fund Bypass Trust*. Consider making a gift from the well spouse to the ill spouse (or to a QTIP trust for the ill spouse) so that that the dying spouse has sufficient assets to be able to fully fund a bypass trust (though this is less important with portability).

(8) *Split Gifts*. Split gifts are possible, with the gift being made either by the ill spouse or the healthy spouse, but adverse tax results can result if the gift may be included back in the estate of the donor (such as a gift with a retained income interest). See Item 5.g.(4) above regarding payment of any gift taxes by the healthy spouse.

(9) *Private Annuities*. Private annuities work well in a low interest rate environment, but if the client dies within 18 months, the client will be presumed not to have had a 50% likelihood of living one year and the actuarial tables will not be available for valuing the annuity.

j. *Miscellaneous*.

(1) *Consider Marriage*. Marry a long-term partner to qualify for the marital deduction. ("Suck it up, no matter how unprincipled you think marriage is.")

(2) *GST Planning*. Consider taking steps to cause estate inclusion in the estate of G-2 in order to avoid a generation-skipping transfer tax.

(3) *35% Tests*. If §§303 or 6166 apply, take steps to bolster the estate's ability to satisfy the 35% test by contributing nonbusiness assets into the business or disposing of nonbusiness assets.

(4) *Losses*. "Harvest" losses before death to utilize a loss deduction and avoid a step-down in basis at death.

(5) *Sales to Grantor Trusts*. The trust should consider repaying the note before death to remove the argument of whether there would be gain recognition with respect to post-death payments. If needed, the trust could borrow money from a third party to pay off the note with cash, and the bank could be repaid following death. Alternatively, the grantor could purchase appreciated assets from the grantor trust, preferably in return for cash (if a note is used, there is the possibility that the note would have a substituted basis). See Item 10.e above.

(6) *Grantor Trusts*. Continue having the grantor pay income taxes on grantor trust income. If liquidity is needed to be able to pay the income taxes, the grantor could borrow money from family members to pay the taxes; the note to family members would have been given for full consideration so it should be deductible for estate tax purposes.

(7) *Upcoming Sale by Grantor Trust.* If the grantor trust will be selling assets in the near future, the assets should be sold before the grantor's death, so the income taxes will be payable by the grantor's estate (generating an estate tax debt deduction) rather than being a liability of the trust following the grantor's death.

42. Post-Mortem Planning

a. *Income Tax Planning More Important.* With the increase of the estate tax exemption amount, and the increased income tax rates that apply to estates, income tax planning will become a more important post-mortem planning issue. The federal estate tax rate is approximately the same as the income tax rate on ordinary income (which applies after only about $12,000 of income for estates or trusts).

b. *Fiscal Year Selection.* For decedents dying in 2012, consider electing a November 30 fiscal year so that undistributed income from the estate through November 30, 2013 will not be subject to the 39.6% high income tax bracket or the 3.8% Medicare tax on net investment income. See Item 9.k above.

For estates of decedents who do not die in 2012, a January 31 fiscal year end may defer the recognition of income. For example, if a decedent died in February of 2011, selecting a fiscal year of January 31 means that in any distributions in the first fiscal year will carry out income to the beneficiary and are deemed received on the last day of the fiscal year, or January 31, 2012, so would be included the beneficiary's income tax for 2012, reported on the return filed in 2013.

If a "qualified revocable trust" makes the §645 election, the trust can take advantage of the estate's fiscal year during the time the election is operable. (Funded revocable trusts typically will want to make the §645 election.)

c. *Income Shifting.* Carefully consider the income tax impact of distributions on the estates and beneficiaries to determine whether making current distributions or accumulating distributions by the estate during a particular year is preferable.

d. *Election of Deducting Administration Expenses*. There is an election for deducting most administration expenses on either the estate income tax return or on the estate tax return. The general rule is that **estate management expenses** (as described in Reg. §§20.2055-3(b)(1)(i) & 20.2056(b)-4(d)(1)(i)) should always be deducted on the income tax return if there is a substantial marital or charitable deduction. Taking an estate tax deduction would not result in any estate tax savings, and would forego getting any income tax savings. On the other hand, for **estate transmission expenses** (as described in Reg. §§20.2055-3(b)(1)(ii) & 20.2056(b)-4(d)(1)(ii)) there is no clear answer. Taking a current income tax deduction will usually increase the estate tax (or under a marital deduction formula clause, may operate to decrease the amount of assets passing to the non-marital share or reduce the DSUE amount if portability is elected, see Reg. §20.2056(b)-4(d)(1)(iii)(4)). However, deducting estate transmission expenses on the income tax return may yield more savings if the marginal income tax bracket exceeds the marginal estate tax bracket or if the surviving spouse's estate is not subject to estate tax because of future law changes and increases in the estate tax exemption amount and reductions to the estate tax rates.

As a way to assure that estate management expenses are deducted on the estate tax return if there is a surviving spouse, the estate tax return could state that the estate waives the right to take as estate tax deductions all administration expenses other than management expenses, which the estate elects to deduct on the estate tax return. That should preserve the right to take estate management expenses as an estate tax deduction.

Many planners are now starting to take the position that at the first spouse's death, unless the income tax bracket is very low or unless the parties expect huge appreciation, the family is probably better off deducting transmission expenses on the income tax return rather than the estate tax return. That has the effect of reducing the bequest to the bypass trust. However, the idea is to take the "Bird in the hand" income tax savings in light of the uncertainty of the estate tax savings that may be achieved years later with the bypass trust. Another exception might be if the surviving spouse is expected to die in the next several years, and there would not be much appreciation in the bypass trust assets. While many attorneys are tending to take the deduction on the 1041 now and give up on the bypass trust reduction, there is no one answer that fits all.

e. *Retirement Plans*. Review appropriate deadlines. For example, be sure to make the minimum required distributions in the year of death to avoid penalties. Consider rollover elections. For example, the surviving spouse will typically want a spousal rollover IRA, and beneficiaries should consider whether to rollover their interests in IRAs into inherited IRAs.

f. *Disclaimers*. Disclaimers may be used to implement pre-mortem planning (in which event, the will probably provides for a default taker in the event of a disclaimer), or may be used in a remedial manner to fix unintended results. Some of the important issues regarding disclaimers are as follows.

(1) *Timely Disclaimer*. The disclaimer must be made within nine months of the taxable disposition (or if later, after the disclaiming person reaches age 21), §2518(b)(2). (If a beneficiary has a general power of appointment over a trust, the nine-month disclaimer period runs for future beneficiaries as of the time the general power of appointment is exercised or lapses.)

(2) *Acceptance of Benefits.* One of the statutory requirements of a qualified disclaimer is that the disclaiming person "has not accepted the interest or any of its benefits." §2518(b)(3).Because of this requirement, before planners are able to determine whether disclaimers would be appropriate for a particular estate beneficiary, the beneficiary should be wary of accepting any benefits from the estate. The portion of joint property that came from the decedent spouse can be disclaimed. *E.g.,* Ltr. Rul. 199932042. The acceptance of benefits issue can be difficult if the decedent spouse was the sole owner of the residence--and if the spouse continues to live in the house after the date of death before the disclaimer is made. (For example, consider transferring a 1% interest in the house to the surviving spouse before death so that he or she could continue residing in the house with respect to the co-tenant interest. Alternatively, consider providing that the surviving spouse would pay rent until the disclaimer decision is made; or take the position that paying insurance, property taxes, etc. is the functional equivalent of paying rent. The IRS is probably not overly strict about this if the disclaimer is made promptly.)

(3) *Beneficiary of Disclaimed Property.* The surviving spouse may be a beneficiary of a disclaimer trust, but no other disclaimant can have an interest in the disclaimed property. §2518(b)(4).

(4) *Disclaimer of Specific Trust Assets.* After a specific trust asset is disclaimed, it must "leave" the trust and pass to someone other than the disclaimant. Reg. §25.2518-3 (a) (2).

(5) *Fiduciary Powers Over Disclaimed Property.* If the disclaimant is a fiduciary of a trust or fund to which the disclaimed property passes, he or she can exercise fiduciary powers to preserve or maintain the disclaimed property without being treated as accepting the property or any of it benefits. However, the disclaimant fiduciary cannot retain a wholly discretionary power to direct the enjoyment of the disclaimed interest. Treas. Reg. §25.2518-2(d)(2). The disclaimant/fiduciary can retain the fiduciary power to distribute to designated beneficiaries if the power is subject to an ascertainable standard. Treas. Reg. §25.2518-2(e)(1)(i) & 25.2518-2(e)(5)Ex.(12).

(6) *No Retained Limited Power of Appointment.* A significant disadvantage to making a disclaimer is that the disclaimant cannot retain a limited power of appointment over disclaimed assets. Reg. §25.2518-2(e)(2) & §25.2518-2(e)(5)(Ex. 5).

(7) *Remedial Disclaimers.* Examples of possible "remedial" disclaimers include

- disclaimers by children to allow assets to pass to the surviving spouse in order to qualify for the marital deduction, or
- disclaimers to "fix" an overly broad tax apportionment clause (for example, a disclaimer that would result in assets passing to persons who are unexpectedly having to pay estate taxes with respect to assets passing to other individuals, or a direct disclaimer of the right to have estate taxes on property received by the disclaimant paid by another person under the tax apportionment clause, *Estate of Boyd v. Commissioner,* 819 F.2d 170 (7th Cir. 1987)).

g. Gift Tax Returns.

(1) *Unfiled Returns.* Any taxable gifts made by the decedent during life must be reported on timely filed federal gift tax returns. If the executor is aware of taxable

gifts by the decedent for which returns have not been filed, the executor should file returns as soon as possible. Reg. §25.6019-1(c) (executor required to file gift tax return for deceased donor).

(2) *Due Date*. If the donor dies during the calendar year in which a gift is made, the Form 709 must be filed and the gift tax must be paid no later than the earlier of (i) the date (including extensions) the decedent's estate tax return is due or (ii) April 15 of the year following the calendar year in which the gifts were made. I.R.C. §6075(b)(3); Treas. Reg. §25.6075-1(b)(2)(filing); §25.6151-1 (payment). If no estate tax return is required to be filed, the gift tax return is due on April 15 of the following calendar year. Treas. Reg. §25.6075-1(b)(2).

h. *Miscellaneous Alternatives For Consideration.*

- GST exemption allocation.
- "Reverse" QTIP election to allocate decedent's GST exemption to QTIP trust.
- Expanding special powers of appointment to general powers of appointment if doing so could save GST taxes.
- Reformation/construction proceedings to correct unintended results.
- Amending, revoking, splitting, or merging trusts.
- Appointments in further trust.
- Section 754 election by a partnership to achieve an inside step up in basis of partnership assets.
- Section 6161, 6163 and 6166 elections to defer estate tax payments.
- Allocating IRD to marital deduction share, to be reduced by income taxes payable with respect to it.
- Testamentary estate freezes.
- Tax consequences of spousal rights of election.
- Waiver of commissions or whether to receive multiple commissions by multiple executors.

43. Interesting Quotations

a. *Great Expectations?* Larry Frolik observed that older clients are more likely to use trusts "That is because they know more about their kids." Larry calls raising children "the long glide path of descending expectations." – Larry Frolik

b. *Procrastination.* ATRA rewarded procrastination. "Those clients who did not act did not lose anything. For those who did act we may hear about buyer's remorse." – Dennis Belcher

c. *Laziness.* "Hard work pays off in the long run, but laziness pays off now." – Despair.com (as quoted by Dennis Belcher)

d. *We Sue.* We previously called the deceased spousal unused exclusion amount the DSUEA. The regulations use the term "DSUE amount. "This is because if we don't tell clients about portability going forward, what do de do? De sue. – Sam Donaldson

e. *Husbands First.* "Let's do as all Lifetime movies teach us — let's kill the husband." – Sam Donaldson

f. *Georgia PowerPoint*. Holding up fingers to make a point: "This is what we call PowerPoint in Georgia." (Sam also pointed out that his hand was not indexed for inflation and he could not illustrate $5.25 million with his fingers.) – Sam Donaldson

g *Legislation and Razors*. "Sleek and sexy ATRA. It'll cut ya like the razor."– Sam Donaldson

h. *HIT*. "***H***igh ***I***ncome ***T***axpayers are the persons 'hit' by the new maximum rate." – Beth Kaufman

i. *The Longest Day*. In noting that the American Taxpayer Relief Act **of 2012** passed the Senate shortly after midnight on January 1, 2013 and by the House later that day, Ron Aucutt quips that the American Taxpayer Relief Act ***of 2012*** was signed on "December 32, 2012."– Ron Aucutt

j. *Rating the Wealthy*. In discussing the three different thresholds of high income taxpayers for purposes for the new maximum ordinary and capital gains rates, the Pease and PEP limitation, and the 3.8% Medicare tax, Professor Sam Donaldson observed "there are various definitions of high income: the super-rich, the rich, the well-off--and academics." – Sam Donaldson

k. *I Want Only Two Things*. "Beneficiaries just want to know two things. What do I get and when do I get it."– Dennis Belcher

l. *The Best Laid Plans*. There is an old Yiddish proverb: "Man plans and God laughs." – Dennis Belcher

m. *Never Use One Word When Two Will Do*. "The typical assignment says 'I hereby assign and transfer …' If you only 'assign' you are screwed."– Sam Donaldson

n. *Greed*. "The really greedy are among us. I'm not saying you are but you're probably sitting next to one of them."– Sam Donaldson

o. *True Love*. "Nothing says I love you like a gift of an interest in an LLC."– Sam Donaldson

p. *Geography Lesson*. In referring to the differences in the states regarding the treatment of same sex couples, Sam Donaldson observed, "the states are all over the map. True — literally they are all over the map."– Sam Donaldson

q. *Marriage Penalty*. In referring to the income tax marriage penalty, Sam Donaldson observed that "everyone should bear the penalty of marriage." Looking to his wife in the audience, he quickly added "but realize it is not a penalty for me."– Sam Donaldson

r. *Waffle House*. "The Waffle House is a hangover cure available to many in the Southeast part of the country." – Sam Donaldson

s. *D.C at Its Finest*. "The fiscal cliff is not something that we can go out and admire as scenery. It is not a work of nature, it is a work of human nature that strives definitively and unambiguously to assign blame to someone else. It is a pervasive governing principle, basic premise, summum bonum, in Washington D.C. to annoy, impede, embarrass and blame the other folks. That makes it hard to predict or even analyze." – Ron Aucutt

t. *More of the Beltway at Its Finest*. "If the goal was for each side to embarrass the other, I would say well done, mission accomplished. Both sides were successful." – Carol Harrington

u. *Legislative Predictions*. "Prediction can take the form of applying known principles, policies and preferences to a known environment, and then predicting the outcome. When the only known principle, policy or preference is to annoy, impede, embarrass or blame the other folks--that looks not so much to the outcome as to the blame for the outcome--it is not easy at all to predict." – Ron Aucutt

v. *Development of ATRA*. "It's like we were looking at a drunk javelin thrower. You don't want to look, you don't want to watch, but you have to watch because you just don't know where things will end up." – Ron Aucutt

w. *Monday, Monday*. "On December 31, the fifth Monday of December and the 53rd Monday of the year, a legislative compromise seemed to be coming together." – Ron Aucutt

x. *Need More Time?* "Remember how busy you were a month ago? Remember how you wish you could just add a few days to the year? Just run for Congress; you get the privilege of doing that. The Senate debated this into the New Year and passed it in the first couple of hours in the New Year ...."– Ron Aucutt

y. *Congressional Football*. "Those of us accustomed to spending New Year's Day watching football now watched political football with the fumbles, the punts, the dives and fouls, the end-arounds and reverses, even the fiscal scores and the calendar overtime late on New Year's Day." – Ron Aucutt

z. *They're Not Worth It*. "When you are preparing a tax return, always remember that while you're representing a client, the first thing you have to worry about is yourself. We never do anything that might be considered fraud or misleading or anything that would put us in jail; jail is really bad. We don't wish to go to jail. We don't wish to be hit with any kind of fraud penalties and don't want to be disbarred from practice. Those are really bad results. You don't have a single client who is worth taking those risks." – Carol Harrington

aa. *Wondering About Wandry*. "I can't resist 'wandering' about defined value gifts." – Ron Aucutt

bb. *The Wandry Quandry*. "Wandry is a quandary; Petter is better." – Skip Fox

cc. *PacMan*. "We sometimes call grantor trusts 'Pac Man trusts' — they eat the grantor alive if there's too much income tax." – Carol Harrington

dd. *Annual Exclusion Indexing*. Observe an interesting difference in the indexing of the annual exclusion. "Under most of the indexing provisions, the number is rounded to the nearest relevant number. For example the estate tax exemption is rounded to the nearest $10,000 under §2010(c)(3). However the gift tax annual exclusion is rounded down to the nearest $1,000. §§2503(b)(2). Even so, the annual exclusion has increased by 40%, from $10,000 to $14,000 over 11 years, since the indexing was added in 2001." – Observations by Sam Beth Kaufman and Sam Donaldson.

ee. *Millionaires*. "I don't want to be a millionaire — I just want to live like one." W.C. Fields, as quoted by Stacy Eastland

ff. *Wink-Wink*. "Don't write anything you can phone. Don't phone anything you can talk. Don't talk anything you can whisper. Don't whisper anything you can smile. Don't smile anything you can nod. Don't nod anything you can wink." – Gov. Earl Long of Louisiana (as quoted by Stacy Eastland)

gg. *No Winking Allowed*. "Neither the Majority Opinion nor any of the four other opinions filed in the Tax Court found evidence of any agreement —— not so much as an implicit, 'wink-wink' understanding —— between the Taxpayers and any of the donees to the effect that any exempt donee was expected to, or in fact would, accept a percentage interest in MIL with a value less than the full dollar amount that the Taxpayers had given to such a donee two months earlier." *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006)

hh. *Get Over It*. In the pre-mortem planning context, consider marrying a long-term partner to qualify for the marital deduction. "Suck it up, no matter how unprincipled you think marriage is." – Josh Rubenstein

ii. *That One Word*. "There is one word in America that says it all, and that one word is, 'You never know.'" – Jouquin Andujar, St. Louis Cardinals baseball pitcher, who is known for his Yogi-isms (as quoted by John Porter)

jj. *Now That's an In Terrorem Clause!!* "He that bereaves my will, which by God's permission I have now made, let him be bereaved of these earthly joys; and may the Almighty Lord -- cut him off from all holy men's communion in Doomsday; and be he delivered to Satan, the Devil and all his cursed companions to hell's bottom, and there be tortured, with those whom God has cast off or forsaken, without intermission, and never trouble my heirs." – Will of Wolgith from 1046 (as quoted by Ben Pruett)

Ben says — "If you think you can do better than that, be my guest."

kk. *Guns*. "Guns are dangerous for fiduciaries…The first rule is: Never give a gun to an angry beneficiary." – Allen Venet

ll. *Whose Old?* "Who is old? Anyone who is five years older than me." – Larry Frolik

mm. *Higher Math*. "So what is the compromise between $3.5 million and $1 million? It is, of course, $5 million indexed for inflation." – Ron Aucutt

nn. *Love Boring*. "I can't think of a worse gift tax return than an interesting one."– Ron Aucutt

oo. *Losers*. Portability may come in handy if the surviving spouse adopts a retirement philosophy of Powerball or marries up and now, shed of you and your loser ways, can "Ditch the zero and hitch the hero." – Sam Donaldson

pp. *Scholars*. "There is an article coming out in a Law Review 'Death and Taxes and Zombies' — relating to zombies and how werewolves may not be covered by DOMA… If it doesn't matter, an academic wrote it." – Sam Donaldson

qq. *Tired Preparers*. "Form 706s often have no Schedule R (the generation-skipping transfer tax schedule). Why? Do you get to 'R' and you're tired?" – Diana Zeydel

rr. *Memories*. "Indexing the annual exclusion makes it hard for planners—it's always changing. What was the annual exclusion in 2011? That was just two years ago and we can't remember." – Barbara Sloan

ss. *Vocabulary Lesson Needed*. "We only get to use the DSUE amount of the 'last deceased spouse.' Which of those three words is not clear? But we have definitions for those terms." – Barbara Sloan

tt. *Same Boat*. "We've looked forward to the day when the law was permanent and we could lock in plans. The law is now supposedly fixed, but I'm still saying Flexibility, Flexibility, Flexibility." – Barbara Sloan

uu. *What Clients Hate the Most*. "Perhaps no professional shortcoming is more widely despised than procrastination."– Skip Fox

vv. *Don't Get Comfortable.* "The most functional family is just one divorce and one remarriage away from disaster." – Randy Johnston

ww. *Document Retention Policies.* "Most firms have a 'document retention policy' — but it is really a 'document destruction policy.'" – Stanley Wakshlag

xx. *Jury View.* Randy says to realize how conflict waivers will appear to the jury: "I'll be damned. The lawyer knew she was not supposed to do that but got the client to agree to do it anyway." – Randy Johnston

yy. *No Whining Allowed.* "We lawyers get sued. Don't whine about it. Don't make it worse." – Randy Johnston

zz. *Deadlines.* "Do not practice law by your calendar. If you work by deadlines, you will end up getting sued. The deadlines established by the court are not the deadlines in the best interest of your client. Do not wait until the last minute. Do things early — when they need to be done, not when the deadline is."– Randy Johnston

aaa. *What the Nightmares Are Telling Us.* "Do not over commit. That is easier for me to say as an older lawyer because as a young lawyer I did not do it. I would wake up in the middle of the night with a nightmare — that I've discovered is a common nightmare. You are back in college taking a class you didn't know you were enrolled in and you've got to take a final exam the next day. That is your sub-conscious telling you there is something to do you haven't done. You have too much on your plate."– Randy Johnston

bbb. *Worst Pun.* GRATs can have unusual assets. One attorney told of a GRAT with valuable violins in it. Sam Donaldson noted "there were strings attached." – Sam Donaldson

ccc. *Vultures.* "Wealth shifting always brings the vultures off the telephone lines." – Randy Johnston

ddd. *Tax Conference Pimping.* Bruce Stone mentioned Sam Donaldson's DNA in the context of persons who might want to acquire superior DNI. Sam's wife posted this message on Facebook: "Another speaker at the conference speaking about assisted reproduction just told the entire conference that people searching for designer DNA should go no further than to buy Sam's superior genes. My question is how much would they really pay? Now accepting bids." One mutual friend replied "The rest of us had no idea that sperm donor pimping is what goes on at a tax law conference." Sam's brother-in-law posted "Was that other speaker also wearing a sweater vest?" – Sam Donaldson

eee. *Best IRA Audit Question.* In audits of Form 8939 Carryover Basis Election forms, the IRS has included this request of some estates: "Provide a list of assets not owned by the decedent." REALLY? – Beth Kaufman