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IMPACT OF BASIS ON LIFETIME WEALTH TRANSFERS OF APPRECIATED ASSETS

Common practice is to make lifetime transfers of assets with appreciation potential. Such transfers are generally considered tax-efficient for a taxpayer whose estate is large enough to be subject to estate tax at death. If the taxpayer makes a gift to his children up to his available applicable exclusion, the gifted assets *and* all income and appreciation on those assets after the date of the gift are transferred gift and estate tax-free. If the taxpayer waits until his death to transfer the same assets to his children, only the applicable exclusion amount will be sheltered from estate tax and any excess value will be subject to estate tax. Thus, the benefit of the gift is the avoidance of estate tax on the post-gift income and appreciation.

Taxpayers can also make lifetime wealth transfers that do not use applicable exclusion. Such transfers are made when one has already consumed his applicable exclusion, doesn't want to use his applicable exclusion, or isn't willing to part with the current value of his assets and only wants to transfer any future income and appreciation. The taxpayer could transfer assets to a grantor retained annuity trust (GRAT) or sell assets to a grantor trust for his children in exchange for a promissory note. If the rate of return on the transferred assets exceeds the IRC Section 7520 rate (in the case of a GRAT) or the interest rate on the promissory note (in the case of a sale), the excess will be transferred to his children free of transfer tax.[1]

If a taxpayer transfers assets during his life in any of the ways described above, the basis of the assets in the hands of the transferee(s) will equal the basis the assets had in the hands of the taxpayer at the time of the transfer.[2] In contrast, if the taxpayer waits to transfer the assets at his death, the basis of the assets will generally be "stepped-up" (or stepped-down) to the fair market value of the assets as of the date of the taxpayer's death.[3] Accordingly, the cost of the estate tax savings achieved by the lifetime transfer of appreciated or appreciating assets is the potential taxes on capital gains that would be incurred in the post-death sale of those assets.

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[1] *See* David A. Handler and Deborah V. Dunn, *The Complete Estate Planning Sourcebook*, §§ 11.03, 11.06, http://intelliconnect.cch.com

[2] Under Code Section 1015(a), the basis of property acquired by gift is the same as it would be in the hands of the donor (or the last preceding owner that did not acquire the property by gift); however, if such basis is greater than the property's fair market value at the time of the gift (i.e., the property is depreciated), the basis is the property's fair market value for purposes of determining loss (unless the gift is between spouses in which case pursuant to Code Sections 1015(e) and 1041(b)(2) the donee-spouse will take the donor-spouse's basis in all events, even if the property is depreciated). In contrast, the basis of a purchased asset is generally its cost (except an asset purchased by the transferor's spouse which, under Code Section 1041, is treated as a gift). *See* Code Section 1012. However, under Code Section 1015(b), the basis of property acquired by a transfer in trust (other than by gift, bequest or devise) is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer. In the case of a sale of an asset to a grantor trust, the sale is ignored for income tax purposes and as such, there is no gain or loss recognized by the grantor on the sale. Accordingly, under Code Section 1015(b), the trust's basis in the purchased assets is equal to the grantor's basis in the assets at the time of the sale.

[3] *See* Code Section 1014. If the taxpayer's executor elects alternate valuation under Code Section 2032, then the basis of the assets will be their fair market value as of the alternate valuation date.

<u>The Analysis</u>

Given this cost, it is important to carefully analyze whether any contemplated lifetime transfer of a taxpayer's assets is likely to result in less overall tax than if the transfer is not made and the assets are included in the taxpayer's estate at his death. This will be the case if the post-transfer, pre-death appreciation of the transferred assets is likely to be substantial enough that the federal and state estate tax savings will exceed the capital gains taxes on unrealized gains that could be incurred by the recipients in a post-death sale of the assets. *The greater the unrealized appreciation at the time of the transfer, the more post-transfer appreciation required to produce a net benefit.*

Underlying this analysis are the following principles:

1) First, one does not avoid estate tax on the value of assets at the time of a lifetime transfer.[4] If applicable exclusion will be applied to shelter a gift of the assets, then there will be less exclusion remaining to shelter the same value at the taxpayer's death. If assets are transferred to a GRAT or sold to a grantor trust, the value of the assets will be included in the taxpayer's estate (and subject to estate tax) in the form of the retained annuity (in the case of a GRAT) or the note or other consideration (in the case of a sale). **Accordingly, the lifetime transfer avoids estate tax only on the *post-transfer income and appreciation* of the transferred assets.** And a GRAT or sale to a grantor trust for a promissory note creates the additional hurdle of the Section 7520 rate (in the case of a GRAT) or the interest rate on the promissory note (in the case of a sale) before any benefit is achieved.[5]

2) Second, even if assets appreciate after a lifetime transfer, this appreciation may not produce enough estate tax savings to make up for the capital gains cost attributable to the *pre-transfer* appreciation.

Several variables affect the amount of post-transfer appreciation that will be required to offset the loss of basis step-up and yield a net tax benefit:

- <u>Time</u>: The more time between the date of transfer and the date of the taxpayer's death, the less *annual* appreciation will be required to offset the loss of step-up (*i.e.*, total appreciation required divided by a greater number of years yields a lower annual required appreciation).

- <u>Tax Rate on Capital Gains</u>: The higher the total tax rate applicable to capital gains, including federal and state capital gains taxes and the Medicare tax, the greater the amount of appreciation required to offset the loss of step-up.

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[4] However, as will be discussed, a gift of assets on which gift tax is paid will result in some transfer tax savings on the value of the assets at the time of the gift.

[5] Although it should be noted that the GRAT and sale for a note structures create annual hurdle rates while estate tax savings will be based on cumulative appreciation.

- Estate Tax Rate: The higher the total estate tax rate (including any applicable state estate taxes), the less appreciation that is required to offset the loss of step-up.

- Basis as a Percentage of Asset Value at the Time of Transfer: The lower the transferred asset's basis as a percentage of its value at the time of the transfer, the more the asset needs to appreciate after the transfer to offset the loss of step-up.

Example 1 -- Full Basis Gift: To illustrate this last variable, assume Bob has $1 million of applicable exclusion remaining which he uses to make a gift of stock worth $1 million to a trust for his children. The basis of the stock at the time of the transfer is $1 million (*i.e.*, basis equals **100%** of fair market value). When Bob dies ten years later, the value of the stock has increased to $1.5 million. Bob lives in a state without a state estate tax so the estate tax savings from the transfer is **$200,000** (40% federal estate tax rate x $500,000 of post-transfer appreciation on the stock). If the trust is subject to capital gains taxes on a subsequent sale of the stock at a total rate of 25%, then the loss of basis step-up at Bob's death costs the trust **$125,000** (25% x $500,000 of appreciation on the stock). So, the lifetime transfer of the stock yields a net tax *benefit* of **$75,000** ($200,000 estate tax savings - $125,000 capital gains tax cost).

Example 2 -- Low Basis Gift: Now assume the same facts as in Example 1, except the stock's basis at the time of the transfer is $100,000 rather than $1 million (*i.e.*, basis equals **10%** of fair market value). The estate tax savings from the transfer is still **$200,000** (40% x $500,000 of post-transfer appreciation on the stock) but the loss of basis step-up costs the trust **$350,000** in capital gains tax (25% x $1.4 million of appreciation on the stock). So, the lifetime transfer of the stock has a net tax *cost* of **$150,000** to the trust. Despite a 50% increase in the value of the stock between the date the stock was transferred and Bob's death, Bob's children are still worse off than if the transfer had not been made (and the stock had been included in Bob's estate) because of the stock's lower tax basis.

Put differently, with the transfer, Bob's children net **$1,150,000** after the stock is sold for $1.5 million ($1.5 million - $350,000 tax on capital gain). Without the transfer, the $1.5 million of stock would have been included in Bob's estate, $1 million of which would have been sheltered by his remaining applicable exclusion, the $500,000 balance would have triggered $200,000 of estate tax, and the stock's basis would have been stepped-up to $1.5 million. As such, no gain would have been realized on a subsequent sale of the stock for $1.5 million and the children would net **$1.3 million** after taxes ($1.5 million sale proceeds - $200,000 estate tax). So, the transfer has a net tax *cost* of **$150,000** ($1.3 million - $1.15 million).

The **"appreciation hurdle"** is the aggregate (not annual) appreciation required between the date of a lifetime asset transfer and the date of the transferor's death for the estate tax savings to equal the capital gains tax cost. It is arrived at using the following formula:

Capital Gains Tax Rate x (1 - Basis as % of Asset Value) / (Estate Tax Rate - Capital Gains Tax Rate)

Only after the appreciation hurdle is achieved will the lifetime transfer provide a net tax benefit (assuming the asset would be retained until the transferor's death). The appreciation hurdle will vary based on the total capital gains tax rate (federal, state and Medicare tax), the total estate tax rate (federal and state) and the basis as a percentage of the asset value.

The chart below shows the appreciation hurdles based on a total capital gains tax rate of 25% (including federal and state capital gains taxes and the Medicare tax) and an estate tax rate of 40% (assuming no state estate tax). The chart also shows the annual return required based on various time frames to achieve the appreciation hurdles.

	appreciation		Annual return required over X years							
If basis is this % of value	required		5	10	15	20	25	30	35	40
0%	166.667%	$ 266.67	21.67%	10.31%	6.76%	5.03%	4.00%	3.32%	2.84%	2.48%
10%	150.000%	$ 250.00	20.11%	9.60%	6.30%	4.69%	3.73%	3.10%	2.65%	2.32%
20%	133.333%	$ 233.33	18.47%	8.84%	5.81%	4.33%	3.45%	2.86%	2.45%	2.14%
30%	116.667%	$ 216.67	16.72%	8.04%	5.29%	3.94%	3.14%	2.61%	2.23%	1.95%
40%	100.000%	$ 200.00	14.87%	7.18%	4.73%	3.53%	2.81%	2.34%	2.00%	1.75%
50%	83.333%	$ 183.33	12.89%	6.25%	4.12%	3.08%	2.45%	2.04%	1.75%	1.53%
60%	66.667%	$ 166.67	10.76%	5.24%	3.46%	2.59%	2.06%	1.72%	1.47%	1.29%
70%	50.000%	$ 150.00	8.45%	4.14%	2.74%	2.05%	1.64%	1.36%	1.17%	1.02%
80%	33.333%	$ 133.33	5.92%	2.92%	1.94%	1.45%	1.16%	0.96%	0.83%	0.72%
90%	16.667%	$ 116.67	3.13%	1.55%	1.03%	0.77%	0.62%	0.52%	0.44%	0.39%
100%	0.000%	$ 100.00	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

For example, the chart shows that if an asset's basis equals 70% of its fair market value at the time of a transfer, the appreciation hurdle is 50%: the asset must appreciate by more than 50% before the transferor's death to produce a net tax benefit from the transfer. Over a ten-year period, that is 4.14% per year compounded. And that excludes the additional annual appreciation required to beat the 7520 rate in a transfer to a GRAT or the interest rate on a note in a sale to a grantor trust.

Example 3 -- Low Basis Gift Using Chart: Let's again consider stock worth $1 million with a basis of $100,000 (*i.e.*, basis equals **10%** of fair market value) at the time it is transferred during Bob's life. The chart above indicates that the appreciation hurdle is 150%: the stock needs to appreciate by **more than 150%** between the date of transfer and Bob's death in order for the lifetime transfer to yield a net tax benefit. If the stock appreciates exactly 150% to $2.5 million between the transfer and Bob's death, the estate tax savings (40% federal estate tax rate x $1,500,000 of post-transfer appreciation = $600,000) and the capital gains tax cost (25% x $2,400,000 of appreciation = $600,000) are equal.

If cash or another asset with basis *equal* to fair market value (*i.e.*, basis equals **100%** of fair market value) is transferred, the appreciation hurdle is zero and ***all post-transfer, pre-death appreciation*** (or, in the case of a GRAT or sale for a promissory note, all post-transfer, pre-death appreciation in excess of the applicable hurdle rate) will result in a net tax benefit as long as estate tax rates exceed capital gains tax rates. For a transferred asset with basis less than its fair market value, ***all post-transfer, pre-death appreciation in excess of the appreciation hurdle*** will result in a net tax benefit (even though the asset's basis as a percentage of its value will then be even lower).

Example 4 -- Full Basis Gift Using Chart: To illustrate, consider stock worth $1 million with a basis of $1 million (*e.g.*, basis equals **100%** of fair market value) at the time it is transferred during Bob's life. If such stock appreciates just 1% to $1,010,000 between the transfer and Bob's death, the transfer will still produce a (small) net tax *benefit* of **$1,500** (($10,000 post-transfer appreciation x 40% estate tax rate) - ($10,000 taxable gain x 25% tax on capital gains) = $1,500). If such stock appreciates 100% to $2 million between the transfer and Bob's death, the transfer will produce a net tax *benefit* of **$150,000** (($1 million post-transfer appreciation x 40% estate tax rate) - ($1 million taxable gain x 25% tax on capital gains) = $150,000).

Example 5 -- Low Basis Gift After Appreciation Hurdle Achieved: If the stock in Example 4 instead has a basis of $400,000 (*e.g.*, basis equals **40%** of fair market value), it has an appreciation hurdle of 100%. In other words, if the stock appreciates less than 100% between the transfer and Bob's death, the transfer will produce a net tax *cost*. If the stock appreciates exactly 100%, the transfer will produce no net tax cost or benefit. Any appreciation in excess of the first 100% will produce a net tax *benefit*. If the stock appreciates 200% to $3 million between transfer and Bob's death, the transfer will produce a net tax *benefit* of **$150,000** (($2 million post-transfer appreciation x 40% estate tax rate) - ($2.6 million taxable gain x 25% tax on capital gains) = $150,000). So, once the stock achieved the 100% appreciation hurdle, the additional 100% of appreciation achieved the same $150,000 net tax benefit as the first 100% of appreciation achieved for the full-basis stock in Example 4.

Surprisingly, transferring a slower-growing asset with a high basis may provide a greater net tax benefit than a faster-growing asset with a low basis.

Example 6 -- High-Growth, Low Basis Asset vs. Low-Growth, High Basis Asset: Assume Bob wants to make a $1 million gift to a grantor trust for his children using his remaining applicable exclusion and he is debating whether to transfer Asset A or Asset B. Asset A is worth $1 million, is growing at a rate of 8% per year and has a tax basis of $100,000. Asset B is also worth $1 million, but is growing at a rate of 4% per year and has a tax basis of $900,000. Bob's life expectancy is ten years and he does not plan to sell either Asset A or Asset B during his lifetime. In ten years, assuming Asset A and Asset B continue to appreciate at their respective annual rates, Asset A will be worth $2.15 million and Asset B will be worth $1.48 million. If Bob dies in ten years, the net tax *cost* of having transferred Asset A would be **$52,500** (($1.15 million post-transfer appreciation x 40% estate tax rate) - ($2.05 million taxable gain x 25% tax on capital gains) = -$52,500), and the net tax *benefit* of having transferred Asset B would be **$47,000** (($480,000 post-transfer appreciation x 40% estate tax rate) - ($580,000 taxable gain x 25% tax on capital gain) = $47,000).

Although Asset B is growing at half the rate of Asset A, a lifetime transfer of Asset B would likely produce a net tax benefit while a lifetime transfer of Asset A would likely produce a net tax cost. This is because Asset A's basis is only 10% of its value and, based on the chart above, it has an appreciation hurdle of 150%, while Asset B, with basis that is 90% of its value, has an appreciation hurdle of only 16.67% .

An even better tax result could be achieved in the foregoing example if Bob gives Asset A to the trust, and then manages to exchange Asset A for high basis assets shortly before his death (such that Asset A will be included in his estate and receive a basis step-up). This illustrates a significant benefit of using a grantor trust: the grantor can purchase, exchange or substitute appreciated assets for higher basis assets without triggering gain realization. Without a grantor trust, this option is foreclosed.

A grantor's substitution of high basis assets for his grantor trust's low basis assets will produce capital gains tax savings. However, if between the substitution and the grantor's death the trust's high basis assets appreciate substantially less than the low basis assets it exchanged, the estate tax cost of the substitution may end up exceeding the capital gains tax savings. Also, an asset swap of this nature puts the trustee of a grantor trust in the difficult position of deciding whether it is in the best interests of the trust's beneficiaries to part with a successful, appreciating asset in order to avoid the gain. This could be an especially tricky decision if the trust is GST exempt or if any of the trust's beneficiaries are different than the beneficiaries who would benefit from the asset the trust gave up upon the grantor's death. Of course, if the trust can use its new assets to purchase the same assets it gave up (*e.g.* the trust uses the cash it receives in the substitution to purchase the same stock it gave up on the open market), it will be a win-win for the trust.

<u>Gifts Triggering Gift Tax</u>

A lifetime gift of a low basis asset on which gift tax is paid (*i.e.*, because the taxpayer has no remaining applicable exclusion) needs to appreciate far less to yield a net tax benefit than a lifetime transfer on which no gift tax is paid.[6] In Example 2 above, Bob, using his remaining applicable exclusion, made a gift of stock worth $1 million with $100,000 basis to a trust for his children. When Bob died ten years later, the value of the stock had increased to $1.5 million. The estate tax savings resulting from the transfer was **$200,000** (40% estate tax rate x $500,000 post-transfer appreciation) but the loss of basis-step up ended up costing the trust **$350,000** (25% tax on capital gains x $1.4 million of appreciation on the stock). So, the lifetime transfer of the stock had a net tax *cost* of **$150,000**. However, if Bob had paid gift tax on the transfer of the stock (because he had no applicable exclusion remaining), the result would have been a net tax *benefit*:

- <u>Gift tax cost</u>: Bob would have paid $400,000 of gift tax at the time of the gift (40% gift tax rate x $1 million gift).

- <u>Gift vs. estate tax savings</u>: The gift tax is tax-exclusive (*i.e.*, it is imposed only on the value of the property gifted and not on the amount of the gift tax paid). In contrast, the estate tax is tax-inclusive (*i.e.*, it is imposed on the value of the entire taxable estate including the amount that is used to pay the estate tax). In other words, the estate tax includes a "tax on the tax." As such, the gift tax is cheaper than the estate tax. For example, a $1.4 million outlay is required to make a $1 million gift ($1 million gift + $400,000 gift tax). In contrast, to leave $1 million at death requires a $1,666,666 gross estate ($1,666,666 - (40% of $1,666,666) = $1,000,000). Accordingly, on a $1 million transfer the effective federal estate tax rate is 40% ($666,666 tax / $1,666,666 total) and the effective gift tax rate is only 28.57% ($400,000 tax / $1,400,000 total). So, if Bob had made the lifetime gift of the stock and paid $400,000 of gift tax, Bob would have saved the 11.43% difference in the effective estate and gift tax rates: **$114,300** (11.43% of $1 million savings on gift vs. estate tax).

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6 This is true unless the taxpayer dies within three years of the gift in which case the gift taxes paid are included in the taxpayer's estate. *See* Code Section 2035(b).

- Capital gains tax cost after basis increase: Under Code Section 1015(d)(6), the trust's basis in the stock would have been increased by an amount which bears the same ratio to the amount of the gift tax paid by Bob ($400,000) as the stock's pre-gift appreciation ($900,000) bears to the amount of the gift ($1,000,000). So, the basis of the stock would have been increased by $360,000 ($400,000 x ($900,000 / $1 million)), bringing total basis to $460,000. So, the loss of basis step-up at Bob's death would have cost the trust **$260,000** (25% x ($1,500,000 - $460,000)).

- Net savings: So, the the lifetime transfer of the stock would have had a net tax benefit of **$54,300** ($200,000 estate tax savings on appreciation + $114,300 savings on paying gift vs. estate tax - $260,000 capital gains tax cost).

The combination of the difference in the effective estate and gift tax rates and the additional basis step-up attributable to the payment of gift tax is powerful enough to make lifetime gifts of many assets on which gift tax will be paid beneficial from a tax perspective. In some circumstances, this will be the case even if the asset *declines* in value after the transfer!

Based on a total capital gains tax rate of 25% (including federal and state capital gains taxes and the Medicare tax) and an estate tax rate of 40% (assuming no state estate tax), the chart below shows the appreciation hurdles for the estate tax savings resulting from a lifetime gift of an asset on which gift tax is paid to equal the capital gains tax cost:

	appreciation			**Annual return required over X years**							
If basis is this % of value (before gift)	**required**			**5**	**10**	**15**	**20**	**25**	**30**	**35**	**40**
0%	57.143%	$	157.14	9.46%	4.62%	3.06%	2.29%	1.82%	1.52%	1.30%	1.14%
10%	40.476%	$	140.48	7.03%	3.46%	2.29%	1.71%	1.37%	1.14%	0.98%	0.85%
20%	23.810%	$	123.81	4.36%	2.16%	1.43%	1.07%	0.86%	0.71%	0.61%	0.54%
30%	7.143%	$	107.14	1.39%	0.69%	0.46%	0.35%	0.28%	0.23%	0.20%	0.17%
40%	-9.524%	$	90.48	-1.98%	-1.00%	-0.67%	-0.50%	-0.40%	-0.33%	-0.29%	-0.25%
50%	-26.190%	$	73.81	-5.89%	-2.99%	-2.00%	-1.51%	-1.21%	-1.01%	-0.86%	-0.76%
60%	-42.857%	$	57.14	-10.59%	-5.44%	-3.66%	-2.76%	-2.21%	-1.85%	-1.59%	-1.39%
70%	-59.524%	$	40.48	-16.55%	-8.65%	-5.85%	-4.42%	-3.55%	-2.97%	-2.55%	-2.24%
80%	-76.190%	$	23.81	-24.95%	-13.37%	-9.12%	-6.92%	-5.58%	-4.67%	-4.02%	-3.52%
90%	-92.857%	$	7.14	-41.01%	-23.20%	-16.13%	-12.36%	-10.02%	-8.42%	-7.26%	-6.38%
100%	-109.524%	$	(9.52)	-162.48%	#NUM!	-185.49%	#NUM!	-191.02%	#NUM!	-193.50%	#NUM!

As you can see, if the asset's basis is at least 40% of its fair market value at the time of the gift, the asset can actually decrease in value and the gift will still have resulted in a net tax benefit. At 50% basis, it can decrease by 26.19% before eliminating the net benefit.

Application of Basis Analysis to GRATs and Sales

The analysis of estate tax vs income tax savings is different in the context of a GRAT. Because a GRAT can transfer wealth without using any gift/estate tax exemption, it is like using gift tax exemption that won't exist in the future or annual exclusions that expire at year end. One must use GRATs during their lifetime to transfer wealth or else the opportunity is lost. The net estate tax benefit is the appreciation over the Section 7520 rate. **The net benefit of the transferred appreciation is the spread between estate tax rates (federal and state) and capital gains tax rates.** As long as the estate tax rate is higher, there a net benefit. **The net benefit is greater when the asset has a higher tax basis.**

In Example 5 above, stock was gifted with a basis of $400,000 (*e.g.*, basis equals **40%** of fair market value), the stock appreciated 200% from $1 million to $3 million, and producing a net tax *benefit* of **$150,000** (($2 million post-transfer appreciation x 40% estate tax rate) - ($2.6 million taxable gain x 25% tax on capital gains) = $150,000). The gift produced a net benefit because the growth exceeded the equilibrium hurdle of 100%. If that stock had been transferred to a GRAT with a 3.2% 7520 rate, there would be $1.968 million of stock remaining when the GRAT terminates, with a basis of $262,400[7], and net transfer would have been **$360,800** (($1.968 million transferred x 40% estate tax rate = $787,200) - ($1.7056 million taxable gain x 25% tax on capital gains = $426,400) = $360,800).

So, even though a GRAT has its own appreciation hurdle (7520 rate) to be successful, it will nearly always be lower than the appreciation hurdle for an asset with basis less than fair market value.

A sale of assets to a grantor trust for a note is similar to a GRAT in that it doesn't use any exemption. However, a GRAT is only successful if the grantor survives the term and all of the annuity payments have been made. Any assets not transferred by the GRAT "for free" will be owned by the grantor at get a step-up at death. In a sale, the grantor could die before the note is repaid, leaving more of the appreciated assets out of the estate and the estate holding the note. The grantor trust might be sitting on more appreciated stock than it would net if the note were fully repaid, resulting in loss of step-up on stock where there was no additional value out of the estate. For example, if one sells $10 million of low basis stock to a trust for a note, and at death the stock is worth $12 million and the unpaid note balance is $9 million, the net transfer is $3 million but $12 million of stock didn't get a step-up! The loss of step-up can easily put the transaction into the "loss column." On the other hand, if the trust paid off the note shortly before the grantor's death by transferring $9 million of stock to the grantor, the $3 million estate tax benefit remains but $9 million more of the stock received a stepped-up basis. So, the estate tax/capital gains tax trade-off analysis for a GRAT applies to a sale, but only to the extent the note has been repaid (or the trust no longer owns the appreciated stock) at the grantor's death.

<u>Limitations and Caveats</u>

The lifetime transfer of an *income-producing* asset will remove not only the future appreciation but also the post-transfer income with respect to the asset from a taxpayer's estate. And, unlike post-transfer *appreciation*, post-transfer *income* enhances the estate tax savings without a corresponding capital gains tax cost. In its current form, the model above does not take this into account.

Also, it probably goes without saying that the foregoing analysis is only applicable to the assets of a taxpayer (or a grantor trust) that are expected to be retained until after the taxpayer's death (*e.g.*, art, homes) and does not apply if the gain will be recognized before the taxpayer's death (*i.e.*, there will be no step-up).

Finally, the estate tax is a certainty and is assessed all at once. In contrast, taxes on capital gains will only be incurred if and when an asset is sold and as such, the timing of capital gain taxes can be managed and even avoided if the basis of the assets is stepped-up later by inclusion in another person's estate. Life insurance, which is paid on the insured's death free of

[7] Allocating the original $400,000 of basis pro rata.

income tax, can be used as a hedge against either or both estate and capital gains taxes and to eliminate the risk of a transfer with a net tax cost.

<u>Impact of basis on lifetime wealth transfers of depreciated assets</u>:

Basis will be **stepped-down** under Section 1014 if at the owner's death the fair market value of an asset is greater than its tax basis (assets that have depreciated in value). And the one-year rule of Section 1014(e) doesn't apply here: if assets are transferred between spouses, and the recipient spouse dies within one year and leaves the asset back to the donor spouse, the basis of depreciated assets *will* be stepped-down.

Gifts of depreciated assets ordinarily do not preserve the basis for purposes of determining loss. Section 1015(a) provides that the basis of property acquired by gift is the same as it would be in the hands of the donor (or the last preceding owner by whom it was not acquired by gift), except that if such basis is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value. Thus, if property with basis less than fair market value is gifted, the basis is not immediately adjusted down to fair market value, because that property may appreciate and ultimately be sold for a gain. But if the property is ultimately sold for less than the fair market value at the time of the gift, the loss will be disallowed to the extent the fair market value was less than basis at the time of the gift. In other words, the donee is not permitted to deduct any *pre-gift* loss on the item, and can only deduct those losses that occurred after the gift. Therefore, one should not gift assets with basis greater than fair market value unless the donor is confident it will appreciate enough to eliminate the loss before death.

For example, an asset worth $50 with a basis of $100 is gifted. If:

a. The asset is later sold for $110. The taxable gain is $110 - $100 basis = $10.

b. The asset is later sold for $75. The taxable loss would normally be $75 - $100 basis = $25 loss, but under the rule above, the basis for determining the loss would be $50 (the FMV at time of the gift). Thus the loss would be $0 ($75 - $50 deemed basis would be a gain, but the rule doesn't create a deemed gain; it only reduces the loss).

However, under Code Section 1015(e), a transfer by gift or sale of a depreciated asset *to one's spouse* will preserve loss.[8] Thus, spouses could transfer depreciated assets to the healthier spouse so the unrealized loss can be preserved and utilized, and not eliminated at a spouse's death by a step-down in basis.

Also, one can *sell* depreciated assets to a grantor trust or a non-grantor trust. If sold to a grantor trust, Section 1015 does not apply because it is not a gift, the transaction is disregarded

[8] Section 1015(e): "In the case of any property acquired by gift in a transfer described in section 1041(a), the basis of such property in the hands of the transferee shall be determined under section 1041(b)(2) and not this section." Section 1041 states that in the case of a transfer of property between spouses, the basis of the transferee in the property shall be the adjusted basis of the transferor (unless the transferor is a nonresident alien).

and the trust assumes the transferor's basis, preserving the loss for future use. Similarly, if sold to a nongrantor trust, no gain or loss is realized under related party rules, but the loss is preserved for future use.

However, a *gift* to a grantor or non-grantor trust, or to a person other than the donor's spouse, will *not* preserve the basis for purposes of a loss. A gift to a person or non-grantor trust falls under Section 1015, as does a gift to a grantor trust. Section 1015 is based on whether a gift has occurred, and is not based on whether there is a new owner for income tax purposes.[9]

Planning for depreciated assets is *just as critical* as planning with appreciated assets, except that *keeping* the asset in the estate will always result in a net tax cost if the asset does not change in value or appreciates. For example, assume an asset is worth $100 with a basis of $150. If the taxpayer dies holding the asset, the basis is stepped-down and the cost to the family is use of the $50 loss, or $10 ($50 x 20%, assuming a 20% capital gains tax rate). If the asset is transferred by gift (to spouse only) or sale, the loss will be preserved, saving $10 plus the estate tax on any post-transfer growth. If that asset appreciates by 100% after the transfer to $200 (so FMV now exceeds basis), the net tax savings is $30: $40 estate tax savings on the $100 of appreciation less the $10 capital gains tax cost from loss of step-up ($200 - $150 basis x 20%).

The family will be ahead if depreciated assets are transferred and do not depreciate further because the low basis will be preserved and any post-transfer income and appreciation avoid estate tax. But if the depreciated assets decrease in value after the transfer, the loss will be preserved but there will be an estate tax cost unless transferred to one's spouse: The loss is only preserved if *sold* to third party (including a trust), and if the asset declines in value after that transaction, the trust and estate could be worse off, especially if sold for a note.

9 See PLR 9109027. For the same reason, the basis will be increased under Section 1015 if gift tax is payable on a gift to a grantor trust.

REVIVAL OF THE MARITAL ESTATE TRUST: THE FULL BASIS STEP-UP AT EITHER SPOUSE'S DEATH

I. The Dilemma

Married couples with high value/low income tax basis assets often face several dilemmas in their attempts to maximize the basis step-up in assets at death under Section 1014 of the Code. For example, they must decide how their assets should be held. As a general rule, most couples cannot divine which spouse will be the first to die. Thus, if all of the assets are held by one spouse and that spouse is not the first to die, then none of the assets will receive a basis step-up until the second spouse's death. Alternatively, if each spouse holds half of the assets, then only half of the assets will receive a basis step-up under Section 1014(a) at the first spouse's death.

If it becomes apparent which spouse will die first, the couple may attempt to transfer all assets to such spouse in order to benefit from a full basis step-up in all of the assets at such spouse's death. However, Section 1014(e) provides that if appreciated property was acquired by the decedent by gift within one year of his or her death, and such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), then the basis of such property in the hands of the donor (or spouse) is the adjusted basis of such property in the hands of the decedent immediately before his or her death. Thus, last minute attempts by a healthy spouse to transfer assets to the dying spouse will fail to provide a basis step-up for such assets if the property is bequeathed to or in trust for the benefit of the healthy spouse.

Some have tried forming joint revocable trusts, with each spouse transferring property to the trust and holding a general power of appointment over the trust property. However, the Service has ruled at least twice that upon the first spouse's death, although all the trust assets will be included in the deceased spouse's estate under Section 2041 by reason of the general power of appointment, the assets transferred to the trust by the surviving spouse will *not* receive a basis step-up under Section 1014 to the extent those assets pass to the surviving spouse (outright or in trust). The transfer to the joint trust is considered an incomplete gift by the spouses, which prevents the one-year clock from beginning to run in order to escape Section 1014(e). See Letter Rulings 200101021 (January 5, 2001) and 200210051 (December 10, 2001).

II. The Estate Trust Strategy

To resolve the estate tax dilemma mentioned above, one may utilize a so-called "Estate *Trust*" as a means of obtaining a full basis step-up for *all* of the assets used in the strategy at the first spouse's death.

What is an Estate Trust? An Estate Trust is a type of trust that qualifies for the gift and estate tax marital deductions under Sections 2523(a) and 2056(a), respectively, because: (i) the property passes to a trust for a spouse's benefit and (ii) upon the spouse's death the property in the trust is paid to the spouse's estate. Because no person besides the spouse receives an interest in the trust property, the trust does not create a "terminable interest" under Sections 2523(b) or 2056(b). Therefore, an Estate Trust does not need to meet the requirements of a general power of appointment (GPA) marital trust or QTIP marital trust. Thus, Estate Trusts may have very flexible terms and need not mandate that all income be distributed to the beneficiary-spouse.

Example. The following illustrates the strategy:

Transfer to Marital Estate Trust. One or both spouses transfer assets to Marital Estate Trusts for the benefit of the other.

Retained Power to Control Time and Manner of Distributions. Each spouse would retain the power, in his or her individual capacity (as grantor) and with respect to the Estate Trust he or she created, to (i) amend the trust agreement to change the manner or timing of the beneficiary-spouse's enjoyment of the income or principal of the trust and (ii) direct the trustee to make or refrain from making proposed distributions of income or principal (which power would be exercisable by his or her agent under a power of attorney in the event of incapacity). As stated above, retaining this power will cause the trust property to be included in the grantor's estate under Section 2038.

The grantor should be prohibited from serving as a trustee, because his Section 2038 powers should be exercised only in a non-fiduciary capacity. If he is serving as a trustee, it would be difficult for him to exercise his Section 2038 powers (in a non-fiduciary capacity) if doing so would breach his fiduciary duties as trustees.

Moreover, the spouse-beneficiary cannot be the sole trustee during any time distributions are permitted in the trustee's discretion. The spouse is prohibited from making such discretionary distributions and there would be deemed to be a vacancy in the trusteeship. If the spouse could make such distributions to himself or herself, there may not be valid trust at all because the sole beneficiary would have the absolute right to vest the trust property in himself or herself.

III. The Results- Why the Estate Trust Works

Estate Inclusion But No Estate Tax At First Death. Assume H dies first (although the results are identical if W dies first). The property in the Estate Trust created by W *for* H will be paid to H's estate, and will be includible in H's estate under Section 2033. Moreover, the property held in the Estate Trust created *by* H for W will be included in his estate under Section 2038 because H will have made a transfer where the enjoyment thereof was subject at the date of his death to a change through the exercise of a power to alter, amend, revoke, or terminate.

Section 2038 provides that if a decedent makes a transfer of property in trust and "the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) . . . to alter, amend, revoke or terminate . . .," such property will be included in the decedent's estate. In particular, Reg. Section 20.2038-1(a) provides:

> Section 2038 is applicable to *any power* affecting the *time or manner of enjoyment of property or its income*, even though the identity of the beneficiary is not affected. For example, Section 2038 is applicable to a power reserved by the grantor of a trust to accumulate income or distribute it to A, and to distribute corpus to A, even though the remainder is vested in A or his estate, and no other person has any beneficial interest in the trust. [emphasis added]

Thus, H's retained power to affect the timing or manner of W's enjoyment of the property of the Estate Trust he created for W will cause the property of that trust to be included in his estate under Section 2038.

No estate tax would be due at H's death because H's estate would receive a full marital deduction for the property included in his estate. The property H's estate received from the Estate Trust that W created for his benefit could pass to W or to a trust for W that qualifies for the estate tax marital deduction, or could use H's remaining estate tax credit. Moreover, the property held by the Estate Trust H created for W qualifies for the marital deduction because such interests passed to an Estate Trust which qualifies for the estate tax marital deduction under Section 2056(a). For such purpose, property is considered as having "passed" from a decedent to a surviving spouse "if such interest has been transferred to such person by the decedent *at any time.*" <u>See</u> Section 2056(c)(4).

Basis Step-Up. Pursuant to Section 1014(a)(1), the basis of property in the hands of a person acquiring the property from a decedent (or to whom the property passed from a decedent) shall be the fair market value of the property at the date of the decedent's death. Under 1014(b)(1) and (b)(3), property is considered to have been acquired from or to have passed from the decedent for purposes of 1014(a) if such property was:

- "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent" (Section 1014(b)(1));

- "transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to *alter, amend, or terminate* the trust" [emphasis added] (Section 1014(b)(3)); or

- "acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of the subtitle B or under the Internal Revenue Code of 1939." (Section 1014(b)(9)). Reg. §1.1014-2(b)(2) states, "this paragraph includes property acquired through the exercise or non-exercise of a power of appointment where such property is includible in the decedent's gross estate."

Section 1014(b)(1) would provide a basis step-up for the property paid to H’s estate from the Estate Trust created by W, and Sections 1014(b)(3) and 1014(b)(9) would provide a basis step-up for the property in the Estate Trust created by H. Thus, *all* of the property transferred to the Estate Trusts will receive a basis equal to the fair market value of such property at H’s death.

Section 811(d)(2) of the 1939 Tax Code includes property in the gross estate “To the extent of any interest therein of which the decedent has at any time made a transfer (except in ease of a bona-fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of decedent's death;” This is the predecessor to Section 2038.

Completed Gift. It is critical that the grantor retain enough power to cause basis step-up under Section 1014, but not so much power as to cause the gift to the trust to be incomplete for gift tax purposes. Otherwise, the 1-year rule of Section 1014(e) will apply precluding a step-up if the donee spouse dies first (unless the assets do not pass to the donor spouse). Reg. Section 25.2511-2(b) provides: “As to any property . . . of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case.” For example, in the case of a traditional irrevocable trust, if the grantor retained a power to name new beneficiaries or change the interests of beneficiaries as between themselves, the gift would be incomplete. However, Reg. Section 25.2511-2(d) provides that a gift will not be considered incomplete if the donor reserves the power to *change the time or manner of enjoyment* of the trust property. Specifically, Section 25.2511-2(d) provides:

> A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment. Thus, the creation of a trust the income of which is to be paid annually to the donee for a period of years, the corpus being distributable to him at the end of the period, and the power reserved by the donor being limited to a right to require that, instead of the income being so payable, it should be accumulated and distributed with the corpus to the donee at the termination of the period, constitutes a completed gift.

In the case of the Estate Trust, the donor would simply retain the power to alter the *manner or timing* of the spouse’s beneficial enjoyment of the income and principal, and would not be able to name new beneficiaries or change the interests of beneficiaries as between themselves. Thus, the gifts by the spouses to the Estate Trusts will be completed gifts.

Confluence of Code Provisions. The three Code provisions relied upon to make the Estate Trust strategy work – Sections 2511 (completed gift), 2038/811(d)(2) of the 1939 Tax Code (estate inclusion), 1014 (basis step-up) – all contain the similar language. All three provisions are triggered by powers to "change" or "alter, amend, revoke, or terminate" enjoyment of trust property. See Sections 2038(a) and 1014(b)(3) and Reg. §25.2511-2(d). However, Section 2038 is not required since step-up can be obtained under Section 1014(b)(3) without inclusion in the gross estate.

Reciprocal Trust Doctrine. If both spouses create Estate Trusts, the two Estate Trusts should have different provisions in order to avoid the reciprocal trust doctrine.[10] For example, one trust could provide for distributions in the trustee's sole discretion, while the other permits distributions for health, support, happiness and welfare. The trusts could also have different trustees. Differentiating the trusts will help defend against an attack that the trusts are part of a "sham," form over substance transaction or were created solely for tax avoidance purposes. However, even if the reciprocal trust doctrine applied, it should not adversely affect the strategy, because the doctrine is applied only to identify the transferor of property for *estate tax inclusion purposes*. See, e.g., Estate of Green v. U.S., 68 F.3d 151 (6th Cir. 1995); Exchange Bank and Trust Company of Florida v. U.S., 694 F.2d 1261, 1269 (Fed. Cir. 1982) ("the reciprocal trust doctrine merely identifies the true transferor, but the actual basis for taxation is founded upon specific statutory authority"); U.S. v. Grace, 395 U.S. 316 (1969).

Why Not a QTIP Marital Trust or GPA Marital Trust? Neither a QTIP marital trust nor GPA marital Trust could be used in lieu of an Estate Trust in order to achieve the same results. Because all trust income would be required to be paid to the spouse, the spouse creating the QTIP or GPA marital trust would not have the power to alter the time or manner of enjoyment of the *income*, and as a result Section 1014(b)(3) would not apply to obtain a basis step-up.

Further, in the case of a QTIP marital trust, Section 2523(f)(5) provides that qualified terminable interest property "shall not be includible in the gross estate of the donor spouse," except after the donee spouse's death after such property has been included in the donee spouse's estate under Section 2044. Thus, notwithstanding any powers retained by the grantor over a QTIP marital trust for his or her spouse, the property in the trust will not be included in the grantor's estate and thus will not obtain a basis step-up at his or her death under Section 1014(b)(9).

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[10] A general power of appointment should not be used to differentiate the trusts, because such a power would require the trust, to qualify for the marital deduction, to meet the requirements of a GPA marital trust under Section 2056(b)(5). See Reg. §20.2056(c)-(3); Rev. Rul. 75-128, 1975-1 C.B. 308 (holding that a "qualified estate trust" under the then-applicable Section 20.2056(e)-2(b)(1)(iii) that granted a testamentary general power of appointment to the surviving spouse would not qualify for the marital deduction because the trust did not meet the requirements of a GPA marital trust under Section 2056(b)(5)).

IV. Risks

If the beneficiary-spouse of an Estate Trust dies within one year of the trust's creation, and pursuant to that spouse's estate plan such assets pass to the surviving spouse (and possibly if they pass to a trust for the surviving spouse), the basis of such assets will not be stepped-up to fair market value. As stated above, Section 1014(e) provides that if appreciated property was acquired by a decedent via gift within one year of his death and passes from the decedent to the donor of such gift, the basis step-up provided by Section 1014(a) does not apply.

V. Divorce and Right of Reimbursement

As is the case with any form of marital trust, an Estate Trust cannot contain a clause that eliminates the spouse as a beneficiary in the event the grantor and the spouse divorce. Such a clause would make the spouse's interest a terminable interest that does not qualify for the marital deduction.

The trust could include a clause that requires the trust to terminate and distribute the assets to the beneficiary-spouse (W) upon either spouse filing for divorce. H and W could also agree at the time the Estate Trust is established that if the trust terminates under such circumstances, such property will be treated as marital property for purposes of the divorce settlement. Such an agreement is a form of post-nuptial agreement and should be negotiated and documented accordingly.

However, if H and W divorce and the trust remains in existence until H's death, the property will be includible in H's estate but will not qualify for the estate tax marital deduction because W is no longer H's spouse. Would H's estate have a right of reimbursement for the estate tax attributable to such property? Neither Section 2207 or 2207A would provide H's estate a right of reimbursement for property included under Section 2038.

However, Section 2207B provides an estate a right of reimbursement for estate taxes attributable to property included in the gross estate by reason of Section 2036. In the Estate Trust strategy, would the powers retained by H cause the property to be included in H's estate under Section 2036? Based on case law, the answer appears to be "yes."

In Estate of Dolores O'Brien v. Commissioner, 37 TCM 1847-68, TC Memo. 1978-457 (Nov. 14, 1978), the grantor created a trust for the benefit of one beneficiary. The court stated, "Section 2036(a)(2) includes in the gross estate the value of property transferred to a trust in which the decedent retained, either alone or in conjunction with any other person, the right to designate the persons who shall receive the property or income therefrom. This provision encompasses trust property that is subject to a settlor-trustee's discretion to either distribute or accumulate trust income thereby affecting enjoyment of the property."

In Estate of Alexander v. Comm., 81 T.C. 757 (Oct. 19, 1983), the decedent had created a trust during his lifetime for the benefit of his daughter, Louise, of which the decedent was the trustee. The trust income could be distributed to Louise or accumulated, as the trustee desired. The trustee was to distribute $5,000 of principal beginning when Louise attains age 21 until she is 66, when she was to receive all of the trust property. If Louise died before age 66, the trust property would be paid to her estate. Thus, like a Marital Estate Trust, there is only one beneficiary and the grantor retained the power to control the beneficiary's present enjoyment of the trust income. The Tax Court in Alexander stated:

> While the decedent's right to accumulate income at his discretion allowed him to restrict Louise's current enjoyment of trust income, it could not be used to deny her eventual dominion over the trust assets, whether income or corpus. . . Louise was both income beneficiary and remainderman of the trust, and for this reason, petitioner contends, the power to accumulate income in the trust could not constitute the right to "designate the persons who shall possess or enjoy the property or the income therefrom" . . .
>
> To be sure, the decedent did not retain the right to designate the recipient or recipients of trust assets in the event that Louise died prior to termination of the trust. In this sense, it might be said that Louise, rather than the decedent, had the right to designate the persons, other than herself, who would possess or enjoy the property and any accumulated income. But, as is borne out by the case law, the boundaries of section 2036 are not to be drawn so narrowly, because the statute is concerned with *present* enjoyment of property through the income therefrom, and not simply with control over the vesting of future interests in the property. Thus, in Struthers v. Kelm, 218 F.2d 810 (8th Cir. 1955), a decedent retained the right, with two others, to accumulate or distribute the income of three trusts, and though the trusts were silent on the subject, it was considered to be determined as a matter of applicable state law that the decedent could not deprive the income beneficiaries of control over the remainder interests. Still, the court held that the predecessor of section 2036(a)(2) required inclusion of the trusts in the decedent's gross estate, and in reaching this conclusion it applied the reasoning of the Supreme Court's interpretation of the predecessor of the analogous section 2038, I.R.C. 1954, in Lober v. United States, 346 U.S. 335 (1953), and Commissioner v. Estate of Holmes, 326 U.S. 480 (1946) . . .

Thus, to avoid section 2036(a)(2) it is not enough that the settlor-trustee does not retain the right to determine to whom trust income or corpus will go in the event that the named beneficiary dies prematurely. The right of the settlor-trustee to deny to the named beneficiary the present enjoyment of the trust income is a right of designation within the scope of the statute. See Estate of Rott v. United States, 321 F. Supp. 654, 655 (E. D. Mo., 1971) ("By accumulating income, the decedent could determine whether the beneficiaries, their estates, or such persons as the beneficiaries had appointed by will would possess or enjoy the property or the income from the property transferred to the trusts"); Estate of Ritter v. United States, 297 F. Supp. 1259, 1262-1263 (S.D. W.Va.

1968). See also Estate of Carpenter v. United States, an unreported case (W.D. Wis. 1980, 45 AFTR 2d 80-1784, 80-1785).

In Struthers, the court stated:

> [T]he case law makes this abundantly clear. It is well settled that section 2036(a)(2) requires inclusion of both the original principal and the accumulated income of an irrevocable trust in the settlor's gross estate where at the time of his death the settlor retains the discretionary power either to distribute trust income to income beneficiaries or to accumulate such income and add it to principal; *the power to deny to the trust beneficiaries the privilege of immediate enjoyment* and to condition their enjoyment upon their surviving the termination of the trust has been considered to be of sufficient substance to qualify as a power to "designate" within the meaning of section 2036(a)(2). United States v. O'Malley, 383 U.S. 627; Industrial Trust Co. v. Commissioner, 165 F.2d 142 (C.A. 1), affirming in this respect Estate of Milton J. Budlong, T.C. 756. See also sec. 20.2036-1(b)(3), Estate Tax Regs. (Emphasis supplied.)

Therefore, the Estate Trust should be includible in H's estate under Section 2036, in addition to Section 2038. Thus, in the event H and W divorce and the property of the Estate Trust is included in H's estate, H should have a right of reimbursement for the Estate Trust's share of his estate taxes under Section 2207B.

However, if H and W divorce, H relinquishes his powers over the Estate Trust in order to avoid estate inclusion altogether but then dies within three years of such relinquishment causing the property of the Estate Trust to be included in his estate under Section 2035, does H's estate have a right of reimbursement for the estate taxes?[11] Neither Section 2207B nor any other Code section provide a right of reimbursement for property includible under Section 2035. That being the case, is H better off retaining his powers over the Estate Trust in the event of divorce? The trust property will remain in H's estate under Sections 2036 and 2038, but H will have a right of reimbursement for estate tax under Section 2207B. On the other hand, inclusion of the trust property in H's estate *may* put the estate into a higher estate tax bracket, and Section 2207B does not entitle the estate to reimbursement for the *incremental* tax, but only to its pro rata share.

Alternatives are to have H's powers automatically lapse upon divorce (pursuant to the trust agreement) or for H to direct the trustee to distribute all of the trust property to W.

[11] Section 2035(a) provides that if (a) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and (b) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

A lapse of H's retained powers is not tantamount to his "relinquishment" of those powers for purposes of Section 2035. Section 2514(e) provides that a lapse of power of appointment is considered a release of the power, which is treated as a taxable exercise of the power under Section 2514(b).[12] The fact that a Code provision is required to cause a lapse to be treated as a release (which is synonymous with a relinquishment) suggests that a lapse of a power ordinarily is not tantamount to a release/relinquishment.

VI. Conclusions

Marital Estate Trusts can finally assume a place in the estate planner's arsenal. They can be used to effectively achieve a basis step-up at the first spouse's death, allowing the survivor to sell all of the assets without imposition of capital gains tax. If executed properly, Estate Trusts take the guesswork out of titling property in spouses' names to achieve maximum basis step-up at the first death.

[12] But only to the extent property over which the power of appointment could have been exercised exceeds the greater of $5,000 or 5% of the aggregate value of the assets out of which the exercise of the lapsed power could be satisfied.

UPSTREAM POWERS OF APPOINTMENT (U-POWER)

Many clients today are focused on using their increased gift, estate and GST exemptions before they sunset on December 31, 2025, or a new administration introduces legislative changes that reduces them even earlier. Many of these same clients are the wealth creators in their family, whose parents or grandparents do not have significant wealth. With these facts, clients may consider a planning technique that relies on the available exemptions of the senior generation to create income and transfer tax benefits.

The planning technique, which we label the "upstream power of appointment," or the "U-power," grants a testamentary general power of appointment ("GPA") to a senior generation (either parents or grandparents) over assets in trusts created by the client for the client's children. The benefits, pitfalls and practical issues of the U-power are described below.

A. Benefits of the U-Power

The U-power offers two potential benefits for the client, both resulting from the fact that a GPA will cause the trust assets subject to the GPA to be included the estate of the senior generation.[13]

First, the estate tax inclusion should trigger a basis step-up under IRC Section 1014. Section 1014(b)(4 provides a step-up for a GPA *exercised* by will and Section 1014(b)(9) provides a step-up for property "acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise *or non-exercise* of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939.[14] With highly appreciated assets, the basis step-up represents significant future income tax savings.

Second, the senior generation will be able to allocate available GST exemption to the trust assets. When assets are included in the senior generation's estate, the senior generation will become the "transferor" for generation-skipping transfer tax purposes and, as transferor, may allocate available GST exemption.[15] . This allows an otherwise non-GST exempt trust to become GST exempt, protected from transfer tax as long as it remains in trust.

B. Implementation of the U-Power

[13] IRC Code Section 2041.

[14] Section 811 of the 1939 IRC includes property in the estate "To the extent of any property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed executed in contemplation of or intended to take effect in possession or enjoyment at or after his death, or (3) by deed under which he has retained for his life or any period not ascertainable without reference to his death or for any period which does not in fact end before his death (A) the possession or enjoyment of, or the right to the income from, the property, or (B) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom; except in case of a bona fide sale for an adequate and full consideration in money or money's worth".

[15] IRC Section 2652(a)(1)(A); Treas. Reg. Section 26.2652-1(a)(2).

1. Formula GPA

GPAs are routinely granted to beneficiaries of non-GST exempt trusts under a formula that will cause some or all of the assets to be included in their estate at death to avoid triggering GST tax when the assets pass from the client's children to the grandchildren. This also achieves a basis step-up and allows a *younger* generation to allocate their GST exemption to trust assets. The U-power uses the same concept to obtain these benefits much earlier: upon the death of a *senior* generation.

The U-power should be granted to the senior generation over the lesser of: (1) the GPA holder's remaining GST exemption (the "GST cap") and (2) the maximum amount of the trust which, if included in the GPA holder's estate, would not cause any federal or state estate tax to be due, considering all other assets included in the GPA holder's estate (the "estate tax cap").

The formula is designed to achieve two results.

First, it is important that the U-power not exceed the GPA holder's remaining GST exemption or the GPA could accelerate a generation-skipping transfer.

For example, assume a trust is created by the client of which the client's children are the sole beneficiaries. If the senior generation has a U-power, the assets will be included in a senior generation's estate, shifting the transferor for generation-skipping transfer tax purposes from the client to the senior generation.16 The assets will be treated as passing from the senior generation to the trust, constituting a direct skip subject to GST tax unless the senior generation has enough GST exemption to allocate to the included assets. If the client's spouse is a beneficiary of the trust, the GPA will not trigger a direct skip until the spouse dies, and any distribution to the children before that would be a GST taxable distribution. However, the same distribution to the client's child would *not* have been a generation skipping transfer if the client had remained the transferor for generation-skipping transfer tax purposes (*i.e.*, absent the GPA).

Second, it is important that the U-power not exceed the amount that can pass free from federal and state estate taxes in the GPA holder's estate— after taking into account the disposition of the rest of the GPA holder's estate. If the GPA formula was simply equal to the GPA holder's remaining applicable exclusion, it could wreak havoc with the GPA holder's estate plan. For example, assume the senior generation's estate was $6 million which he leaves to his three children (including your client), the trust over which he has a GPA is worth $10 million and the GPA was over his applicable exclusion, assumed to be $11 million. Without the GPA, his $6 million estate would pass estate tax free to his three children. But the poorly drafted GPA formula increased his estate to $16 million, $5 million more than his applicable exclusion. Unnecessary estate taxes are triggered, and depending on the tax apportionment in the GPA holder's will, some of the tax might be borne by his other children, who will not be happy with your client (or you). Attention must also be paid to whether the senior generation resides in a state with an estate tax (or with a high estate tax exemption).

Although simple in concept, it is worth considering a few nuances to the formula.

[16] *Id.*

2. Mitigating Federal and State Estate Tax Return Filing Obligations

A formula GPA equal to the senior generation's applicable exclusion could trigger a federal or state estate tax return obligation, as well as basis reporting, for the senior generation's estate, which otherwise would not have existed. Clients may be reluctant to implement an estate planning technique that increases the administrative burden and costs on the death of a parent or grandparent, as well as the possibility of an audit. To avoid this result, the GPA could be granted in an amount equal to $100 (or some other dollar amount) less than the estate tax cap.

The executor of the GPA holder's estate may still choose to file a federal or state estate tax return (for example, to manually allocate GST exemption). However, by drafting the formula to avoid increasing the GPA holder's estate to the filing threshold, you preserve flexibility whether or not to do so. Further, even if the executor chooses to file an estate tax return when one is not required, there should be no basis consistency reporting obligations under IRC Section 6035.

If an estate tax return is or must be filed by the executor of the GPA holder's estate, then the trustee of the client's trust should be directed to pay the expenses associated with the estate tax return filing and any resulting basis reporting obligations. You could limit this direction to the circumstance where such returns would not have been required but for the GPA, or expand the direction to include 'voluntarily' filed returns.

Finally, even if no estate tax return ultimately is filed, appraisals may be required. The date of death fair market value of illiquid or unmarketable assets held in the client's trust (and in the GPA holder's estate) will be needed to appropriately identify the amount of the trust subject to the GPA, and to allocate GST exemption.

3. Allocation of GST Exemption

It is important that the assets subject to the GPA can be fully protected from generation-skipping transfer tax (*i.e.*, to create an inclusion ratio of 0). As noted earlier, if they are not, then the grant of the GPA could accelerate a generation-skipping transfer by shifting the transferor to a senior generation.

Ideally, the GPA would be granted over a non-GST exempt trust (*i.e.*, a trust with an inclusion ratio of one to which the client has not allocated GST exemption). This maximizes the benefits of the U-power. The U-power can achieve both the potential income tax savings from the basis step-up and the efficiency of utilizing a senior generation's unneeded GST exemption to make the client's trust GST exempt. As importantly, granting the GPA over a non-GST exempt trust avoids duplicative use of GST exemption by the client and the senior generation for the same assets. GST exemption allocated by the client to assets subject to the GPA and includible in the GPA holder's estate will be lost once the transferor shifts to the GPA holder, but they continue as GST exempt using the senior generation's exemption.

If only part of client's non-GST exempt trust is subject to a GPA, the trust will become two trusts for generation-skipping transfer tax purposes after the GPA holder's death: a non-GST exempt trust of which the client is the transferor and a trust of which the senior generation is the transferor (and to which the senior generation allocates GST exemption).[17] There will not be a trust with an inclusion ratio between 0 and 1, and a qualified severance will not be needed.

The GPA holder's GST exemption can be allocated manually or automatically. GST exemption may be allocated manually at death on a timely filed federal estate tax return. If GST exemption is not allocated on a timely filed federal estate tax return, then automatic allocation rules will apply.[18]

The automatic allocation rules first allocate GST exemption to direct skips occurring at the death of the transferor. This may include the client's trust if the *only* beneficiaries are the client's children and more remote descendants, and one or more of the beneficiaries could receive distributions from the trust currently.[19] However, if the client's spouse is a beneficiary of the trust, then the trust would not be a skip trust. The automatic allocation rules could still apply, but would allocate to the assets subject to the GPA as a 'second priority', and only after GST exemption was fully allocated to any direct skips. Further, the GPA holder's GST exemption would be allocated proportionately over all trusts created by such person from which a generation skipping transfer *could* occur, and not only to the client's trust.[20] As a result, the assets subject to the GPA could exceed the GST exemption allocated to the assets.

To avoid this result, practitioners either will want to ensure that the client's trust is a direct skip so that the formula will appropriately absorb remaining exemption, even if automatic allocation rules are relied on, or ensure that proper coordination with the GPA holder's current estate plan and with the executor of the GPA holder's estate will occur. This could lead to tension between the client and his siblings, each vying for the parent's GST exemption to be allocated to trusts for their benefit.

<u>For example</u>, assume client transferred $20 million to a trust for client's spouse and descendants. Assume client's parent has a $2 million estate and client's parent's estate plan contributes all of the estate to a trust for client (or client's sibling) and the remainder to client's (or client's sibling's) descendants. Assume also that client's parent used $1 million of gift/estate tax exemption on a gift during life to a trust for the benefit of client, client's sibling, and their children and allocated no GST exemption to it, worth $2 million at the parent's death. Assume client's parent will die resident in a state with no estate tax and with $10 million of remaining federal estate tax and $11 million of GST exemption. The formula will grant client's parent a GPA over $10 million (the lesser of the GST cap and the estate tax cap). Unless a federal estate tax return is filed, manually allocating client's parent's available GST exemption, the automatic allocation rules will allocate the $11 million of GST exemption among all of: (i) the $10 million of assets subject to the GPA, (ii) client's parent's $2 million lifetime trust and (iii) the $2 million residue of client's estate, pro rata. Assuming no administration expenses are paid, then:

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[17] IRC Section 2654(b)(1).

[18] IRC Section 2632(e)(1).

[19] IRC Section 2613(a)(2)(A).

[20] IRC Section 2632(e)(2).

- the $10 million of GPA assets will be allocated 10/14 of the available $11 million of GST exemption ($7.85 million);

- the $2 million lifetime trust created by client's parent will be allocated 2/14 of the available $11 million of GST exemption ($1.57 million); and

- the $2 million residue of client's parent's estate will be allocated 2/14 of the available $11 million of GST exemption ($1.57 million).

None of the assets will have an inclusion ratio of zero.

The above-described result can be avoided in a few ways.

First, an estate tax return could be filed for the GPA holder's estate to manually allocate GST exemption to fully protect the assets subject to the GPA. This approach certainly will require coordination with the executor of the GPA holder's estate, and likely will require coordination with the GPA holder's estate plan. The GPA holder may need to direct her executor to make the manual allocation in this way at her death in order to avoid liability issues for the executor of the GPA holder's estate, and potential conflict at the GPA holder's death.

Second, you could confirm that no other trusts which could have generation skipping transfers have been created by the GPA holder during her lifetime, or will be created by her before or at her death. This would eliminate any competing trusts to which automatic allocation rules could apply, but would require coordination with the GPA holder's estate plan and a commitment by GPA holder not to change the estate plan without notice.

Third, you could draft the formula to reduce the GST cap by the value in any trusts created by the GPA holder during her lifetime or at her death which could have a generation skipping transfer. This may lead to an inefficient use of the GPA holder's GST exemption. It could limit the amount of the GPA, and shift allocation of GST exemption to assets which ultimately may be distributed to the GPA holder's children (rather than grandchildren).

Finally, your client's trust, over which the parent will be granted the GPA, could be drafted to qualify as a direct skip trust. In that case, the GST cap will work appropriately and grant a GPA in an amount of remaining GST exemption, reduced by the other direct skips at the GPA holder's death. The GPA assets will be fully protected from GST tax, even if GST exemption is allocated under automatic allocation. This approach likely is the most foolproof of the four, but would require your client's spouse to not be a beneficiary (or to not be a beneficiary of the assets subject to the GPA).

4. Prioritizing Assets Subject to the GPA

One of the benefits of the U-power is that it triggers a basis step-up under IRC Section 1014 because of inclusion in the GPA holder's estate. However, not all assets in a trust will benefit equally from the basis step-up, and without direction, a fraction of all of the trust assets would be included in the estate (and get stepped-up). For example, if a trust has $1 million of cash and $1 million of low basis stock, and the senior generation has a GPA over $1 million (50%) of the trust, then the GPA would be over 50% of the cash and 50% of the stock, increasing the basis of only half the stock. Instead, the formula can prioritize assets over which the GPA is granted.

For example, practitioners should consider granting the GPA first over trust assets that would realize a short-term gain if sold immediately prior to the GPA holder's death, and next over assets that would realize a long-term capital gain if sold immediately prior to the GPA holder's death.

You also might grant the GPA over specific assets held in the trust first. For example, you may grant the GPA over stock in a closely held business or low or even negative basis real estate. After that apply the GPA to short-term gain assets, then long-term gain assets, then to shares which qualify as qualified small business stock, and then to full basis assets last. But in all events, you may wish to specify that the GPA will not be granted over any assets with a basis greater than fair market value. This will avoid a step-down in the asset's basis, which could cost more than the benefit of making the assets GST exempt. This may be a particularly valuable limitation on the GPA in today's economic environment where assets may be subject, in the short- to mid -term, to significant volatility. Additionally, you may wish to specify that the GPA will not be granted over any policies of life insurance owned by the trust where a basis step-up is not material, or over qualified opportunity zone investments if there is a risk that the GPA could create a disposition event, accelerating gain realization on those investments.

Given the possibilities for tailoring the GPA, you may consider giving the trustee the power to restrict the GPA in the future, or may even consider a trust which does not immediately incorporate the U-power but preserves the potential for it in the future. For example, the trustee may be given the discretion to grant or eliminate a GPA entirely, or only over specific assets, or to limit the GPA to a percentage of the trust assets. This kind of planning flexibility may prove important to respond to changing economic and legislative environments.

5. Coordinating Among Family Members

The U-power relies on the senior generation having insufficient assets, independent of the GPA, to trigger a state or federal estate tax, or to fully allocate GST exemption. With current exemption levels as high as they are, the senior generation may still have sizeable assets but still be a candidate for the U-power. In that case, it is important to consider how the U-power affects client's siblings in order to avoid disadvantaging them. For this reason, it may be safest to grant U-power only to the *surviving* parent (or grandparent) in a senior generation, rather than to the first parent (or grandparent) to die. If you assume that the first spouse to die's estate plan will benefit only the surviving spouse at his death, then the U-power may absorb estate and GST exemption at the death of the first spouse to die which otherwise would have been shared with client's siblings.

For example, assume client's parents have a $7 million estate. Client's father dies and leaves his entire estate outright to client's mother, and the estate elects portability at a time when the client's father's remaining estate and GST exemptions are $11.5 million. At the mother's subsequent death, assume that the available estate tax exemption has decreased to $6 million. Absent the U-power, even with decreased exemptions, client's mother should be able to fully protect her estate from estate tax. She will have $17.5 million of exemption, after taking into account the $11.5 million DSUE from her husband's estate. However, if client's father had been granted a U-power using up his estate tax exemption, portability would not have applied at client's father's death. Client's mother would have a $7 million estate, and only $6 million of estate tax exemption. The step-up in basis and utilization of client's father's GST exemption achieved by the U-power would come at the cost of the estate tax on client's mother's estate (*i.e.*, the estate tax on the $1 million by which her estate would exceed available exemption). Of course, in weighing the possibilities, it is important to contemplate the possibility that an estate which appears well below current exemptions could grow in value over time and exceed them by the date of death of the survivor. Alternatively, legislative changes could reduce exemptions creating the same issue.

Therefore, any grant of a u-power to the first spouse to die should include careful consideration of the senior generation's estate plan and the consequences of the GPA to the intended beneficiaries of that estate plan.

Similarly, often, although client may have been a wealth creator in a family, client's siblings may also have been successful. Under those circumstances, client's siblings may wish to benefit from the U-power in their estate planning as well. You will want to carefully coordinate drafting the formula GPAs in order to avoid granting separate GPA's that together exceeds the GST exemption which can be allocated to the property. (The same caveat is true if client wishes to create multiple trusts, each with a U-power included.)

C. Grantor Trust Treatment Can Continue

If the client's trust is a grantor trust, the mere grant of the GPA will not alter that treatment. Only if the GPA were actually exercised by the GPA holder would the identity of the grantor for purposes of the income taxation of the trust assets change; a mere lapse of the GPA will not change the grantor for income tax purposes.[21] The grantor trust status allows the client, rather than the trust, to bear income tax liabilities on trust assets. That represents an important wealth transfer for client, and wealth accumulation for the trust. The grant of the U-power, assuming it is not exercised, does not turn off grantor trust status.

D. Exercise of the GPA

Clients should recognize that the GPA is a significant power given to the holder.

The GPA, whether exercised or not, exposes the trust assets to claims by creditors of the GPA holder's estate in some states (excluding AK, CO, DE, IN, MD, OK, RI, SC, SD, UT, WY). If the estate has liabilities it cannot pay, the client's trust might be liable to pay them. Client should consider this possibility carefully.

The mere grant of the GPA accomplishes the benefits of the planning technique, and no exercise of the GPA is needed (or even intended). However, the client should recognize that the GPA holder could exercise the power. The GPA can be drafted to minimize the risk of exercise. <u>For example</u>, potential appointees can be limited to creditors of the GPA holder's estate *and* any

[21] Treas. Reg. 1.671-2(e)(5)

exercise of the GPA can require the consent of a non-adverse party.[22] The client can select a trusted non-adverse person to protect against unwanted exercise of the GPA.

The client often will want to know if the senior generation can exercise the GPA in favor of a trust of which the client (the original grantor) is a beneficiary. Technically this is possible, but only with care.

First, the appointee trust should be governed by the laws of a state that protects self-settled trusts from the grantor's creditors and the grantor should not be a trustee and should not have a power of appointment over its trust assets in order to avoid inclusion under IRC Section 2038.

Second, you should be careful to mitigate against a successful step transaction argument by the IRS. Any exercise by the senior generation of the GPA in favor of a trust of which the grantor is a beneficiary could be treated as a pre-arranged plan by which the grantor created the trust for himself. Best practice would be for the senior generation to consult with independent counsel before exercising the power, and after some time has passed since the trust was created.

E. Conclusion

With exemptions at a historic high, and significant uncertainty on whether and for how long they may remain as high, the u-power can afford clients with the right facts the ability to leverage senior generations (or others) to achieve income and transfer tax efficiencies. The technique, while simple in concept, and relying on common planning principles, is fraught with traps for the unwary. This article has outlined some important considerations in implementing a technique which, if used appropriately, can significantly boost a client's estate plan.

[22] IRC Section 2041(b)(1)(C)(ii).

COMPREHENSIVE AND FLEXIBLE TRUST DRAFTING

A financial advisor recently contacted me about a potential new client, asking how much it would cost to prepare “disclaimer trusts” and otherwise generally update their wills and revocable trusts. My response was that I would first need to determine whether disclaimer trusts are the appropriate structure for the client, and the rest would depend on the terms, design and structure of the trusts based on the clients’ objectives and assets. I probably won’t get the client based on the fact that my response included the snarky line, “That’s like removing someone’s tooth without personally assessing the condition of the tooth and determining the best course of action.”

To me, this correspondence was indicative of the way many commoditize trusts, thinking them as generic entities that all generally do the same things. If so, we would all be sales reps for LegalZoom which allow people to assemble their own wills and trusts online.

However, that trust, and the trusts that may stem from it, could last for several decades, or possibly several generations. The trust agreement is the rule book that will govern the assets for a long time, and such a document must be flexible enough to address the thousands of unforeseeable events that *will* occur with respect to the assets, the beneficiaries, and the world at large. My hope is that these materials help you draft better trusts, raising issues and points you may not have previously considered.

This session will focus on trust design, peppered with sample clauses. My breakout panel tomorrow will delve more heavily into suggested and best clauses and provisions.

1. **Trustee Appointment and Removal**

(i) Critical to have flexibility to change who will be trustee, can appoint trustees, remove trustees and under what conditions.

(ii) Don’t limit the trustees to fixed trustee list.

(iii) Empower client, spouse, beneficiaries and others to appoint and remove trustees, and to change who can appoint/remove trustees in the future.

(iv) Give power to specify terms and conditions in which person becomes a trustee, or must cease.

(v) Give power to specify roles and powers of trustees.

(vi) Sample language:

Plan of Trustees. Any of the following persons who are not Incapacitated may establish a plan of trustees for any trust hereunder except as otherwise indicated:

me;

Jane;

the primary beneficiary of a Descendant Trust who has attained thirty-five (35) years of age, but only with respect to that Descendant Trust and any trust created (or to be created) therefrom;

my descendant who is the parent of the primary beneficiary of a Descendant Trust, but only with respect to that Descendant Trust and any trust created (or to be created) therefrom;

a majority of the Senior Descendants of the primary beneficiary of a Descendant Trust who have attained thirty-five (35) years of age and are not Incapacitated, but only with respect to that Descendant Trust and any trust created (or to be created) therefrom;

a majority of the siblings of the primary beneficiary of a Descendant Trust who have attained thirty-five (35) years of age and are not Incapacitated, but only with respect to that Descendant Trust and any trust created (or to be created) therefrom;

a majority of my Senior Descendants who have attained thirty-five (35) years of age and are not Incapacitated; and

(viii) a majority of the non-corporate trustees of the trust.

To the extent of any inconsistency in plans of trustees, (i) the plan established by a person in a superior position (even after the death of such person in a superior position) on the foregoing list (solely for purposes of this Article except as otherwise expressly provided in this Agreement, the "Hierarchy List") shall take precedence over the plan established by a person in an inferior position, (ii) the plan established by the primary beneficiary of a Descendant Trust with respect to any trust created (or to be created) therefrom shall take precedence over a plan established by the primary beneficiary of a trust so created, and (iii) the later plan established by a person shall take precedence over such person's earlier plan. The trusts hereunder need not have the same trustee or trustees, and the failure of a trustee to act as trustee of one trust shall not in itself prevent such trustee from serving as trustee of any other trust.

A plan of trustees may designate initial or successor trustees to begin serving immediately or to serve upon or until the occurrence of a specified event or contingency, may designate an initial or successor trustee for limited or general purposes and accord specific responsibilities and powers (within the mandate of rights and powers given to the trustee in this Agreement), may impose qualifications or requirements, may specify compensation of such trustees, may designate single or successive trustees, and may provide for the imposition of limitations or conditions generally or on the designation of successor trustees, additional trustees or on the removal of trustees serving hereunder, all as provided in the plan. A plan of trustees may empower any person to establish plans of trustees subject to any limitations or conditions and specify such person's place on the Hierarchy List; provided, however, that such person's place on the Hierarchy List may not be higher than those above the person granting the power. A plan of trustees may eliminate any person's power to establish plans of trustees subject to any limitations or conditions and remove such person from the Hierarchy List, but only with respect to a person in an inferior position on the Hierarchy List. Except as otherwise provided in this Article, a plan may leave a vacancy in the trusteeship unfilled. Notwithstanding the foregoing, a plan of trustees may not affect the responsibilities, powers, qualifications, requirements, compensation or impose limitations or conditions generally on the serving trustees. Any references in this Agreement to "the person(s) listed or described" in specific numbers on the Hierarchy List shall continue to refer to the same person(s) notwithstanding changes to the number after which they are listed in the Hierarchy List pursuant to a plan of trustees unless such person is removed from the Hierarchy List with respect to the particular trust.

2. Directed Trusts vs. Multiple Trustees

Control over trusts can be sliced and diced in many ways. There can be different types of trustees each with different powers, such as "distribution trustees," "investment trustees" and "administrative trustees." Distribution trustees can be broken down further to HEMS distribution trustees" and "discretionary distribution trustees." There can also be special trustees whose sole job relates to a specific asset, such as stock in a family business, such as voting the stock or approving distributions or transfers.

Another way to divide the roles is through a "directed trust." Rather than multiple trustees, there is one trustee that takes certain actions at the direction of "advisers" (e.g., distribution advisers, investment advisers, etc.).

c. **Benefits**: Separating these roles can put the right persons in the right jobs, and also relieve each other from responsibility and liability for the other jobs.

d. **Clear Directions**: When using directed trusts to bifurcate investment management and/or discretionary distribution authority from other trustee duties, make clear that the trustee must act solely at the direction of the advisor who is vested with such authority. Language which provides that the advisor "shall have the power to direct the Trustee" or that "the trustee shall follow the direction of the advisor" falls short of expressly stating that the trustee shall exercise certain specific trust powers "solely" or "exclusively" upon the written direction of the advisor. Without the express provision that the trustee shall act solely upon direction, one could argue that the language sets up a simultaneous duty for the trustee to take directions and also to act in its own discretion.

e. **Investment Trustees/Investment Advisors**

(i) **Grantor as Investment Trustee or Investment Advisor**: The Supreme Court held in *Old Colony Trust Company v. U.S.*[23], that no aggregation of purely administrative powers will render the trust property includable in the estate. Also in *Estate of Willard V. King v. Commissioner*[24], the Tax Court held that the decedent's powers to manage the trust's investments did not allow him to control the beneficial enjoyment of trust property under IRC Section 2036(a)(2), because such powers were exercised in good faith and subject to fiduciary duties.

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23 423 F.2d 601 (1st Cir. 1970)

24 37 T.C. 973 (1962)

Nor did such powers over the enjoyment of the property rise to the power to alter, amend or revoke under IRC Section 2038. This holding, which had been reached in several other decisions (although the Service has not acquiesced), was confirmed by the Supreme Court in *United States v. Byrum*. Sample provisions:

> The Investment Trustee shall have sole responsibility and authority, and the trustee shall have no responsibility or authority, for managing the investments of the trust, including the power to purchase, sell and retain all of the trust property, and the power to exercise all voting, subscription, conversion, option and similar rights with respect to such property and to participate in or consent to any voting trust, reorganization, merger, dissolution or other action affecting any such property. The Investment Trustee of a trust may take any action in furtherance of his responsibilities pursuant to this Section, and the trustee is under no duty to review or make recommendations with respect thereto but is required to follow the directions of the Investment Trustee within the mandate of rights and powers given to the Investment Trustee. In furtherance of the foregoing, the Investment Trustee may give investment directions and sign checks, agreements or other documents on behalf of the trust and such direction or signature shall bind the trust in the same manner as though said direction, check, agreement or other document had been given or signed by the trustees, and no person or entity dealing with the Investment Trustee shall be obliged to inquire as to the trustee's acquiescence to such action. With regard to trust assets over which the Investment Trustee has investment responsibility:
>
> (a) The Investment Trustee shall have the duty (i) to provide the trustee with the information necessary to enable the trustee to ascertain the value of trust assets, upon request by the trustee, (ii) to manage or participate in the management of any entity owned by such trust, to the extent such entity's governing instruments or applicable law require the owners to manage the same, (iii) to direct the trustee with respect to making any representation, warranty or covenant required to be made in order to maintain any investment, (iv) to direct and instruct the trustee on the future actions, if any, to be taken with respect to such representations, warranties and covenants, and (v) to direct the trustee to sign agreements and any other documentation required in connection with any trust investment.
>
> (b) The trustee shall have no responsibility and need not inquire into the Investment Trustee's performance of its duties, but the Investment Trustee shall keep the trustee informed of the Investment Trustee's actions. Specifically, no trustee shall be responsible for any review or oversight of any Investment Trustee's investment policies, advice or decisions, notwithstanding the fact that the trustee may receive reports from and communicate with the Investment Trustee regarding the trust assets in connection with the performance of its duties as trustee. The trustee shall not be liable for any act or failure to act by the Investment Trustee, and is hereby exonerated from any liability in connection with any action taken by or upon the direction of the Investment Trustee. No trustee shall be held liable for any loss to any trust hereunder caused by the actions of the Investment Trustee.

During any time that no Investment Trustee is serving with respect to a trust, all of the responsibilities, authorities, rights and powers conferred upon the Investment Trustee pursuant to this Section shall be held by the trustee of such trust.

The Investment Trustee shall act in a fiduciary capacity and possess all of the duties, powers, immunities and liabilities that would otherwise be possessed by the trustee pursuant to this Agreement and applicable law as they relate to the responsibilities of the Investment Trustee as set forth in this Section.

(ii) **Exclusions**: However, the investment trustee/advisor's power should exclude (i) voting shares of stock in a company controlled by the investment trustee/advisor (in an individual capacity) within the meaning of Section 2036(b)(2) of the Code that was transferred to the trust by the investment trustee/advisor, except if in a bona fide sale for adequate and full consideration in money or money's worth; and (ii) exercising "incidents of ownership" (within the meaning of Section 2042 of the Code) with respect to insurance on the investment trustee/advisor's life. Sample provisions:

Restrictions on Investment Trustee. Notwithstanding any provision of this Agreement, an Investment Trustee shall not have any authority, duty or responsibility with respect to:

a. Any life insurance policy owned by the trust of which such Investment Trustee is an insured which prohibition includes but is not limited to the power and authority to acquire, pay premiums, contribute to, withdraw or borrow from such policy; and

b. Voting or other participation in a decision by a "controlled entity" (as hereinafter defined) to make a distribution, dissolve, liquidate, redeem interests or amend its governing instrument if such Investment Trustee at any time transferred (in his or her individual capacity) any interest in such controlled entity to, or in trust for the benefit of (including any trust hereunder), any "members of the Investment Trustee's family" (as hereinafter defined). As used herein:

(i) "controlled entity" means a Business Entity in which the Investment Trustee and members of Investment Trustee's family collectively own, directly or indirectly, at least fifty percent (50%) of the capital, value or profits interest;

(ii) "members of the Investment Trustee's family" means the Investment Trustee's spouse, the Investment Trustee's descendants, the spouses of the Investment Trustee's descendants, and the Investment Trustee's siblings and their descendants.

f. **<u>Administrative Trustee</u>**: A trustee without power to make distributions or manage investments, but solely to handle "administrative" matters for the trust.

1. An administrative trustee can protect the other trustees from liability by keeping accurate records, filing returns and other documents in a timely manner and preparing annual accountings. Frequently, "friends and family" trustees do not adequately handle these tasks.

2. If a full trustee (i.e., a trustee who is not directed and still is responsible for all of the traditional trustee duties) also is acting with an administrative trustee, the full trustee still has a fiduciary duty to supervise the administrative trustee. This means full supervision and periodic review.

3. Typical functions of administrative trustees:

(a) Maintaining custody of the trust property;

(b) Maintaining the trust records;

(c) Maintaining an office for trustee meetings and other trust business;

(d) Preparing any necessary tax returns (to the extent such function is not delegated by the trustees),

(e) Receiving and distributing written notices,

(f) Originating and/or facilitating trust accountings, reports and other communications pertaining to the trust, and

(g) Taking actions necessary to carry out the foregoing.

Some states define the minimum administrative duties that a trustee must carry out in that state in order to have sufficient nexus to avail the trust of that particular state law (e.g., Delaware). See Lewis v. Hanson, Del. Supr., 128 A.2d 819, 826 (1957), aff'd sub nom. Hanson v. Denckla, 357 U.S. 235, reh'g denied, 358 U.S. 858 (1958).

3. Sample language.

If at any time there is more than one Trustee serving and one of those Trustees is [Delaware trustee], then the following powers, authorities and discretions (all of such powers, authorities and discretions herein the "Administrative Powers") shall be carried out in the State of Delaware solely by [Delaware trustee], as trustee, so long as the situs of this trust is in, and this trust is governed by the laws of, the State of Delaware:

(1) To maintain bank accounts, brokerage accounts, and other custody accounts for (i) the custody and safekeeping of the trust estate; (ii) receiving trust income; (iii) making disbursements in payment of trust expenditures; and (iv) making distributions to or for the benefit of Beneficiaries as directed by the trustee.

(2) To maintain storage of stock certificates, tangible personal property or other evidence of ownership of assets held as part of the trust estate;

(3) To maintain trust records;

(4) To maintain an office for Trustee meetings and other trust business;

(5) To originate, facilitate and review trust accountings, reports and other communications pertaining to the trust with the Grantor, any co-Trustees, Beneficiaries and unrelated third parties;

(6) To respond to inquiries concerning the trust from either Grantor, any co-Trustees, Beneficiaries and unrelated third parties;

(7) To execute instruments, agreements, contracts and any other documents with respect to trust account transactions; and

(8) To retain, at the expense of the trust, accountants, attorneys, agents and other advisors in connection with the performance of the Trustee's duties.

3. **Pot/Spray Trusts (not cannabis)**

A single trust for multiple beneficiaries can serve a variety of purposes. For example, owning an insurance policy until the insured's death, owning a residence for the use and benefit of the beneficiaries, keeping assets consolidated to simplify management while children are minors, receiving annual exclusion gifts for a group of descendants or others (which helps the withdrawal rights lapse faster).

Aside from the foregoing situations, keeping assets in a single trust to benefit adult children and their families will lead to dissent, tension and frayed relationships, far outweighing any benefits of a single trust. A single trust could lead to disagreements over investments, distributions and spending. Each beneficiary will have different views on investments, risk, liquidity and diversification. Some will want to invest in start-ups (including their own) or venture capital, while others will want to follow the advice of the late John Bogle of Vanguard funds and invest in no-load, low-cost index funds. Some will have more expensive lifestyles than others, or live in more expensive locations (compare Manhattan, New York City vs. Manhattan, Illinois).

The next thing you know, families who have a gene pool that is less and less in common with each generation are mixed in each other's business, judging each other's life choices and making decisions about each other's financial affairs. This is not a great situation for siblings who at least grew up in the same home, but just imagine at G3 and G4 who are only first or second cousins. Throw in some spouses and you have combustible material.

So here's my advice:

(i) Having a single trust for the benefit of multiple beneficiaries (e.g., the settlor's children) may be practical and sensible when the trust is first established. There is one investment portfolio to manage, one tax return to file, one insurance premium to pay, and the trustee may have flexibility to distribute assets unequally among the beneficiaries if appropriate.

When the beneficiaries are older, they will have their own careers, families, incomes, assets, spending habits, risk tolerances and views about money. Forcing them to share out of the same pool will lead to conflict about differences in distributions/consumption, investment allocations and the like.

Therefore, most trusts should divide into separate trusts for the beneficiaries at some point. Each subtrust would be administered independently, allowing the beneficiaries to conduct their lives free of judgment and conflict with their siblings about how the trusts are being used and invested. Of course, our clients can insert whatever rules regarding distributions they see fit, but each family is free to go their own way.

Timing: Trusts often divide when the settlor and/or settlor's spouse is deceased, but if they live their full life expectancies, that could leave their children sharing a trust until they are in their 60s. Give the trustee discretion to terminate and the divide the trust before that time, or give the trustee the power to distribute some of the assets to subtrusts before the main trust terminates.

4. **Advancement Clauses for Spray Trusts**

c. **The Concept**: During the term of a spray trust, the beneficiaries will reach different milestones in their lives at different times, such as marriage, starting a business, buying a first home, or having a child. That beneficiary might request a relatively large distribution for these purposes, but the trustee may refrain to making the distribution (despite its merit) because $1 to one beneficiary reduces the remainder that will eventually divide among all the beneficiaries. So give the trustee the authority (not necessarily a direction) to treat certain distributions as advancements that reduce the recipient's share of the trust upon termination. Doing so gives the trustee more comfort to make a large distribution from a spray trust without fear of suit by a beneficiary for favoring another beneficiary.

d. **Other considerations**:

Exclude distributions for health care or education?

Exclude distributions if the beneficiary is under a certain age?

Complexities:

a. Include interest?

b. Tracking distributions

e. Sample language:

The trustee(s) who made the determination to make a payment pursuant to this Section to a member of a Family Line that is not for the Health or Education of such person may, in such trustee's discretion, treat any such payment as an "Advancement" for purposes of this Article. Treatment as an Advancement will reduce the amount of such Family Line's future share of the trust property. The trustee shall maintain records of payments treated as Advancements, and any payment that is not so included in the trust records or any payment for which the record is unclear as to such treatment shall not be treated as an Advancement. It is my desire, but not my direction, that the trustee not make an Advancement to a member of a Family Line pursuant to this Section if such Advancement would likely cause the aggregate amount of all Advancements made to such Family Line to exceed the estimated share of the trust property to be allocated to the Family Line upon termination of the trust.

5. **Behavioral/Incentive Clauses**

c. **Tread Lightly**: Many clients think they have it all figured out: They will use trusts to ensure their children and grandchildren won't become "trust fund babies" doing nothing with their lives except getting bottle service with their friends every night. They will require them to graduate from college, have a professional career, submit to drug and alcohol testing, sign prenuptial agreements and be religiously observant. Otherwise, they don't get distributions from the trusts.

I tell my clients that my trusts are not going to correct your parental mistakes. What you couldn't accomplish raising your kids 24/7 for 20 years isn't going to be solved with a 50 page trust agreement. If they are trust fund babies, there's a strong likelihood our clients raised them that way.

The consequences of these clauses may backfire, leading to unintended results, even if the client is no longer around to see it.

d. **Lifestyle Requirements**: These might include work, education, religious or other requirements. There are myriad problems with such clauses. First, interpretation of the clauses would be difficult. Ask ten people of the same religion what it means to be "religiously observant" and you'll get ten answers. Requiring prenuptial agreements? The trust would need to spell out what those agreements must say, and the beneficiaries could instead choose to not marry and avoid it. Those same clients with religious requirements might find their children "living in sin"!

There can be excellent reasons one cannot or chooses not to obtain a traditional college degree, such as the opportunity to start a company like Facebook or Microsoft, or due to an illness or disability. We don't even know how "college" will actually operate in 50 or 100 years; maybe everyone will just obtain certifications with online courses. Cutting of funds for failing a drug test might be worst path: paying for rehab, support and a home might get the beneficiary out of the drug universe.

Such clauses can backfire, cutting a beneficiary off from funds in unintended situations.

e. **Incentive Provisions**: Incentive provisions often take the form of matching a beneficiary's earned income. Incentive provisions are simple in concept, but the potential exceptions can swallow the rule. For example, a trust that matches the beneficiary's earned income creates these issues:

1. Can the beneficiary retire without losing trust distributions?

What if the beneficiary wishes to be a stay-at-home parent?

Beneficiaries in low-paying professions (or doing volunteer) work receive less than those making substantial incomes. For example, a law professor is paid substantially less than an equivalent practitioner. Or a doctor working in a small rural town makes much less than he or she might working in a large urban hospital system.

What if the beneficiary has a mental or physical disability and cannot work or has limited work opportunities? Or if a child of the beneficiary has a disability requiring full-time care by the beneficiary?

At what age must one start working before the matching provisions kick in? Will they be supported through college? Graduate school?

Is it only the beneficiary' earned income that matters, or is it the combined earned income of the beneficiary and his or her spouse?

f. **<u>Trustee Guidance</u>**:

1. Rather than dictating lifestyle and work requirements, consider using guidelines as a statement of values to encourage or discourage certain behaviors or objectives. Not binding/mandatory, not tests.

2. <u>Sample language</u>:

> I request (but do not require) that when determining whether to make a distribution to a descendant of mine from any trust hereunder and the amount of such distribution, the trustee do so in a manner that assists, encourages or rewards such descendant for exhibiting or accomplishing the following "desired behaviors":
>
> a. pursue an education at least through college and/or a vocational/technical school;
>
> b. be gainfully employed with a view toward being financially self-sufficient;
>
> c. be a law-abiding member of society;
>
> d. be a productive member of society by making meaningful and positive contributions to family, community and society;
>
> e. engage in entrepreneurial and/or creative activities;

f. handle money intelligently and avoid wasteful spending;

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

h. develop healthy and meaningful relationships;

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

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

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

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

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

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

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

6. **Definitions of Children and Descendants**

c. **Impact on Gift Splitting**: If spouse elect to split gifts to use both of their gift exclusions or exemptions, or if they use community property to make gifts, consider defining "descendants" as children/descendants "of their marriage," and not just descendants of the grantor. Otherwise, if the spouses divorce and the grantor (H) has subsequent children, those children will benefit from the gift and GST exemptions of the non-donor/splitting spouse (W).

d. **"Unintended" children** (e.g., with a mistress): Define if and when they are included. Children born "of the marriage" of the grantor and grantor's spouse would exclude such children, but what if a grandchild is born out of wedlock? When should such a grandchild be included as a beneficiary of the trust created by the parents or grandparents? If acknowledged by the parent? If raised by the parent? What if the trust was already distributed when they showed up?

e. **Posthumous Children**: Children born after the death of the grantor or a beneficiary (e.g., reproductive technology): Consider whether there should be a time limit on when they have to be born to avoid holding up distributions to other beneficiaries while waiting to see if posthumous children will be born. Require that person previously authorized the use of his or her gametes?

7. **Including Spouses/In-Laws**

This is a difficult topic to discuss with clients because it requires some tenacity to make sure they give it the consideration it deserves. 99% of our clients want to leave most or all of their assets to their spouse, and then to their children, but then deny their children the ability to leave assets to their spouse unless their trusts have terminated.

The fact is, everyone is an in-law. Diagrams of family trees can start wherever one chooses, and everyone is eventually a patriarch or matriarch to their descendants. My mother just an in-law to my father's parents, but she is also my children's grandmother. It would seem odd to my children that they could inherit the Handler family fortune while their grandmother could be excluded.

Put differently, the nuclear family changes over time. Growing up, my parents and siblings were my "family". Now, my wife and children are my family, and my parents and siblings are now "my parents and siblings." When my daughters marry and have their own children, I will face a similar betrayal.

With that in mind, it is worth urging clients to allow their children the *opportunity* to leave assets to their spouses. It could be required that the assets pass in trust with the remainder to grandchildren, and it could be over a percentage or dollar amount. But leaving no opportunity to direct assets to a spouse might leave the spouse with little income if his or her spouse dies with few assets outside the trusts. Many clients say that is the responsibility of their child, but life is unpredictable, and people sometimes die before their financial affairs are fully in order.

In the case of a non-GST exempt trust, appointing the assets to a marital deduction trust, or to a trust for the spouse and children can defer estate and GST taxes, and obtain a basis step-up at the spouse's death in the case of a marital trust.

Finally, consider giving beneficiaries the ability to grant their spouse the right to appoint trustees (or be a trustee) for their children's trusts.

8. **Silent trusts - good or bad?**

Some states allow for "silent trusts" in which the trustee has no duty to (or can be prohibited from) inform the beneficiaries of the existence of the trust, let alone provide information about the assets and investment performance. The desire for such clauses is understandable as most clients don't want their 18 year old children to learn they really don't need to go to college or get a job because they have millions in trust for their benefit. In fact, many clients and trustees don't actually tell such children about their trusts until years later, despite the duty to do so.

These statutes often require appointment of a "designated representative" to receive information and notices about the trust on behalf of the beneficiaries. The designated representative is supposed to protect the interests of beneficiaries who don't even know of the trust. As explained below, there are many practical issues with these clauses.

What does the trustee do or say when the beneficiary learns of the trust's existence? After all, he or she might receive distributions from the trust and K-1's from the trust to report his or her share of the DNI on a tax return. When a beneficiary does learn of his or her trust, what's to stop them from telling their siblings they all have trusts? When they approach the trustee to ask about such trusts, does the trustee claim ignorance?

Further, should such clauses continue potentially indefinitely? Shouldn't the parent of the beneficiary be able to waive the clause, deciding for themselves when their children should learn of their trusts? Certainly if the beneficiary has the power to appoint (or remove) trustees he or she needs to know of the trust. And how can they implement their own estate plans without knowing there are trust assets that will be included in their estates, or that will pass free of estate tax to their children? How can they exercise powers of appointment they don't know exist? There are also life decisions that might be impacted by knowledge of the trust (or lack thereof), such as ability to buy a home or take a risk to start a business. Finally, how does one educate beneficiaries about the purposes of the trust and stewardship of the assets if they aren't informed?

Consider putting an age limit, such as 30, to such clauses and allow the parents to waive the clause. Ensure the beneficiaries can be informed about the trust by the time they could appoint or remove trustees. However, some trusts say the "income beneficiaries" can appoint trustees, which could include beneficiaries of a wide age range.

9. **Private decanting provisions and broad amendment powers by protector**

c. **Decanting**: More and more states are enacting "decanting" statutes that allow the trustee (with notice to or approval of the beneficiaries) to transfer some or all of the trust assets to another trust for one or more of the beneficiaries of the original trust. These statutes have proven to be enormously helpful, allowing trusts to be improved or clarified in many ways, or enhancing their income or estate tax benefits. These can be negated by a trust that specifically precludes the trustee from using these statutes.

Even without a decanting statute, a trust agreement could give the trustee a similar power, perhaps even without notice to or approval of the beneficiaries. These are known as "private decanting" clauses.

Do these statutes and clauses give too much power to the trustee? What's the point of drafting a trust with rules and limitations on distributions and trustees if the trustee and beneficiaries can gang up and change it all in the future? If we tell clients that their irrevocable trusts can be significantly amended via decanting, how often will they "request" the trustee do so, giving the appearance of an implied understanding about amendments which the IRS can use to include the assets in the donor's estate? If the client inserted a private decanting clause in the trust, that might look even worse. Perhaps requiring notice or approval by the beneficiaries will limit the unfettered use and help protect against estate inclusion.

d. **<u>Trust Protector/Power to Amend</u>**: Giving a "trust protector" or other person the power to amend an irrevocable trust has the same benefits, and concerns, associated with decanting. And, if the person the client selected as trustee is their first and best person for the job, to whom do they give the power to rewrite the trust?

10. **Grants and Exercises of Powers of Appointment**

c. **<u>Grants</u>**: Granting a power of appointment is an incredibly flexible way to add flexibility to a trust, allowing a beneficiary to change where and how the assets pass at his or her death (and possibly during life) in light of the circumstances life has thrown his way. It can be as simple as saying, "The beneficiary shall have the power to appoint the trust property upon his death to or in favor of any of his or her descendants." But that leaves many unanswered questions, and powers of appointment need more directions in trust agreements.

(i) If a testamentary power, state that it can be exercised in a will or other document. The latter would avoid having to probate a will to make the exercise effective and could keep the disposition of the trust private.

(ii) State that the power can be effective at a later date. For example, a trust for the benefit of wife owns insurance on husband's life. If wife has a testamentary power of appointment, she likely would prefer it be effective (i.e., the disposition occurs) at the husband's death if she predeceases him. Otherwise, the policy could be transferred to the kids or separate trusts for their benefit, making it more difficult to maintain and administer the policy.

(iii) State whether the power holder can exercise in further trust, and whether those trusts can grant powers of appointment to the beneficiaries that are even broader than the original power. If the power could be exercised outright in favor of the objects (who could then use or dispose of the assets as they wish), there doesn't seem to be a downside to allowing one to grant the object a broader power of appointment.

(iv) State that, if exercised in trust and all potential objects of the power subsequently die, the remainder can pass to others. Otherwise, would the assets have to revert to the original donor's estate?

(v) State whether property added to the trust after the exercise is effective also passes according to the exercise of the POA.

d. **Sample language**:

Exercise of Powers of Appointment. Any exercise of a power of appointment granted pursuant to this Agreement that is to be effective during the life of the holder of such power shall be exercised by a signed instrument delivered to the trustee that expressly refers to such power. Any exercise of a power of appointment granted pursuant to this Agreement that is to be effective upon the death of the holder of such power shall be exercised either by (1) a signed instrument delivered to the trustee, the last such instrument to control, or (2) the Will of such holder admitted to probate in any jurisdiction, provided that such instrument or Will expressly refers to such power. In the event of any conflict between the last such instrument delivered to the trustee and such Will, the provisions of such Will shall control. In the absence of a specific reference to a power of appointment granted hereunder, any exercise of such power shall be ineffective.

Except as otherwise expressly provided in this Agreement:

(1) The exercise of a power of appointment shall be effective on the date indicated in the instrument or Will, as the case may be (the "distribution date"), and may be amended or revoked by the holder prior to the distribution date unless otherwise provided in the exercise; provided, however, that the distribution date may not be after the date on which the trust with respect to which such power was exercised would terminate in default of the exercise of such power, and during the course of administration, the trustee shall not consider the terms of any exercise of a power of appointment prior to the distribution date unless the exercise of such power specifically provides otherwise.

(2) The exercise of a power of appointment may direct that the property subject to the power be disposed of outright or in trust, may impose limitations or conditions, and may grant additional powers of appointment to the object of the power exercisable by Will and/or during life. Such additional powers of appointment granted to an object of the power shall be exercisable only in favor of permissible objects of the power of appointment held by the holder who granted such powers unless such holder is authorized to appoint outright to the object of the power in which case the objects of such additional powers of appointment need not be permissible objects of the power of appointment held by the holder.

(3) If a power of appointment is exercised over all, a percentage or a fraction (and not a specified dollar amount) of trust property, unless otherwise provided in the instrument exercising such power of appointment, any property added to such trust after the effective date of such exercise shall be disposed of in the same

manner as though it had been part of the property of such trust as of the effective date of such exercise (i.e., it shall be disposed of as directed in such exercise).

(4) The exercise of a power of appointment may appoint a different trustee to administer a trust created by the exercise of the power and may change the situs of the trust administration and direct that the trust shall be governed by the law of the new situs or any other jurisdiction. If the exercise of the power does not direct otherwise, a trust created by the exercise of the power shall be administered by the trustee hereof subject to the same management powers conferred on the trustee.

(5) If a power of appointment is exercised in further trust and the last surviving permissible object of the power who is a beneficiary or remaindermen of such trust dies, then notwithstanding any provision of such trust, the remaining trust property shall be disposed of as directed in the Article titled "Ultimate Contingent Beneficiaries," and any such appointment that so provides is valid.

e. **POA Exercise Pitfalls:**

(i) Comply with the requirements for exercise, such as in a will, specific reference to the trust and power of appointment.

(ii) Make sure the exercise is only in favor of proper objects of the power, or it will be invalid. Pay attention to definitions of "descendants," "spouse" and others.

(iii) Ensure any trust created by the exercise (or trust to which assets are added) does not violate the rule against perpetuities clause of the original trust.

(iv) Unless it is a general power of appointment, never exercise in favor of one's own revocable trust. One's revocable trust can leave assets to anyone, and the assets would be used to pay debts and estate taxes, which would exceed the authority under the power of appointment. However, one can exercise in favor of a subtrust to be created under one's revocable trust agreement.

11. **Change of situs/governing law clauses**

c. **Uses**: A clause allowing the trustee to change the situs and/or governing law of the trust can be very useful to allow one to take advantage of more favorable trust laws or state income taxes. However:

(i) Consider the effects of change in the perpetuities period originally applicable to trust. The trust agreement should say that any change in situs or governing law does not affect the RAP.

(ii) Relieve the trustee from duty to monitor the law in all jurisdictions. Leave it to the beneficiaries or their counsel to suggest changes to the trustee.

d. **Sample language:**

Governing Law and Situs.

This Agreement shall be construed and administered, and the validity of each trust hereunder shall be determined, in accordance with the laws of the State of [______], without giving effect to its conflicts of law principles. The trustee may amend this Section and take any other action in order to change the jurisdiction whose law shall govern the construction, administration and validity of any trust hereunder, and to amend any other provision of this Agreement solely for such purposes, but any such change shall not affect the original term of the trust pursuant to the Section titled "Rule Against Perpetuities." The jurisdiction whose law governs the construction, administration and validity of any trust may, but need not, be the same as the situs of the administration of such trust.

The trustee may transfer the situs of the administration of any trust hereunder and/or the location of any trust property to another jurisdiction within or without the United States as often as the trustee deems it advantageous; and the trustee may take whatever action is necessary or desirable (including, without limitation, the commencement of an appropriate judicial proceeding) in order to effectuate such a transfer of trust situs administration or of the location of trust property; and if necessary for the transfer of the situs of the administration of a trust, the persons in the Article titled "Successor and Additional Trustees" empowered to establish a plan of trustees of the trust, or if none, the trustee may designate a person or corporate trustee to assume office as a co-trustee of that trust, and thereafter may act as adviser to such substitute trustee and may receive reasonable compensation for so serving.

The trustee shall have no duty to monitor the laws of other jurisdictions in order to determine whether the powers to change the situs or the jurisdiction whose law shall govern the construction, administration and validity of any trust hereunder should be exercised.

12. **Crummey rights**

c. **<u>Notices</u>**: Giving a beneficiary a right to withdraw a gift can qualify the gift for the gift tax annual exclusion under Section 2503. Under *Crummey v. Comm'r*[25] and *Estate of Clyde W. Turner, Sr. v. Comm'r*[26], written notice (and perhaps actual notice) is not even required, but are advisable. The IRS often asks for copies of any notices in gift tax audits.

(i) In the trust agreement, say the trustee "should" give notice to the beneficiaries, and don't require that it be in writing. This gives the trustee the most flexibility and a stronger argument if the IRS claims the withdrawal right was not effective because the trustee failed to comply with the trust.

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[25] 397 F.2d 82 (9th Cir. 1968).

[26] T.C. Memo. 2011-209 (Aug. 30, 2011).

(ii) The notice should *not* give the beneficiaries an option to waive or release the withdrawal rights. Under section 2514(e), a lapse of a general power of appointment (withdrawal right) is not a gift to the extent it does not exceed the greater of $5,000 or 5% of the trust value, but this exception does not apply to an affirmative "release" of a general power/withdrawal right. A release would be treated as a gift. The notice should simply notify them of their rights.

(iii) Sample Language:

> *Notice of Withdrawal Rights*. The trustee should notify each person granted a withdrawal right of the existence of such right (other than a person who has actual knowledge of such right), but the trustee's failure to provide such notice shall not affect such person's withdrawal right. If a person notifies the trustee of his intention to make annual Additions, the trustee may provide a single notice containing the foregoing information to each person who will be granted a withdrawal right with respect to such annual Additions. If a person granted a withdrawal right is Incapacitated, notice of his withdrawal rights shall be given to his agent under a power of attorney, if any, otherwise to the representative of his estate, if any, otherwise to the guardian of such person, or if no guardian has been appointed, to his parent (other than the donor) or a person with whom he resides (other than the donor), but if there is no such person, to a person who is serving as trustee of such trust (in his individual capacity and not as trustee); provided, however, that the person to whom notice of an Incapacitated person's withdrawal right would be given pursuant to the foregoing provision may designate another person to receive such notice by a signed instrument delivered to the trustee.

d. **Withdrawal Rights for Spouse**: One can include their spouse as a beneficiary of a trust primarily intended for their kids for added flexibility and access to the assets. The spouse can also be given Crummey withdrawal rights, allowing for an additional $15,000 to be contributed to the trust each year. However, if GST exemption is allocated to the trust, make sure the spouse cannot withdraw more than the greater of $5,000 or 5% of the trust value, and that the spouse's withdrawal right will lapse in full within 60 days. Otherwise, the "estate tax inclusion period" (ETIP) will apply and preclude timely allocation of GST exemption until the spouse's withdrawal right lapses.

13. Trustee power to grant or eliminate a power of appointment

c. Estate Tax Inclusion is Generally Preferable Over GST Tax:

(i) If a trust is not GST exempt, it may be subject to generation-skipping tax at the beneficiary's death unless it is included in his taxable estate. It is generally preferable to subject the trust property to estate tax in the beneficiary's estate rather than GST tax because:

(1) The estate tax rate will always be equal to or less than the GST tax rate (which would be applied to a tax-inclusive taxable termination).

(2) Property included in one's estate receives a full basis step-up to its fair market value, whereas the basis of property subject to only to GST tax is stepped-up by the amount of GST tax attributable to the unrealized gain (unless a taxable

termination by reason of death occurs, in which the assets receive a full basis step-up).[27]

(3) The estate tax credit for prior transfers (Section 2013) does not apply to property subject to GST tax.[28]

(ii) Estate inclusion can be triggered by granting a general power of appointment (GPA). However, if the distribution of the trust property at the beneficiary's death will not be a generation-skipping transfer, it may be preferable that the beneficiary not have a GPA. For example, if the beneficiary does not have descendants and the property will pass to his siblings upon his death, no GST tax will be imposed because the property will not pass to skip persons. Therefore, inclusion in the beneficiary's estate could subject the property to an unnecessary estate tax. Similarly, if the beneficiary is expected to exercise the power in a manner that would be damaging to the family (e.g., by distributing stock in the family business to an outsider), the power would be undesirable. Nonetheless, absent such circumstances, subjecting property to estate tax is preferable to GST tax.

d. **Power to Grant or Remove GPA**: Give a disinterested trustee the power to grant or remove a GPA, but only at the beneficiary's request. Otherwise, the trustee could be liable for exercising or not exercising the power. May be advisable based on beneficiary's assets, estate tax exemption and tax basis. Sample language:

> "The trustee may eliminate a current or future beneficiary's power to appoint a portion or all of the property of a trust hereunder to himself, his creditors, his estate, and/or his estate's creditors; to modify such a power by imposing such terms and conditions on its exercise as the trustee determines, in his discretion; or to grant such a power subject to such terms and conditions as the trustee determines, in his discretion; provided, however, that: (i) the trustee shall not exercise this power unless the beneficiary (or if the beneficiary is Incapacitated, his guardian, duly authorized agent or other legal representative), by a signed instrument delivered to the trustee, requests that the trustee do so, (ii) if so requested, the trustee may determine whether or not to exercise this power, in the trustee's sole discretion, (iii) if the trustee determines to exercise this power, it shall be exercised by a signed instrument delivered to the beneficiary, (iv) the trustee shall not be liable for any exercise of, or failure to exercise, this power, and is hereby exonerated from any liability in connection therewith; (v) neither I nor any trustee who is a beneficiary of such trust shall participate in the exercise of this power; and (vi) this subsection shall not apply to a Marital Trust with respect to which a marital deduction has been allowed."

14. Grantor Trusts

[27] IRC Section 2654(a)(1) and (2).

[28] Credit for prior transfers (Section 1013): Estate tax credit allowed for a decedent's estate tax for "property" "transferred" by or from a person who died 10 years before or 2 years after the decedent. Starts at 100% if during first two years, and declines from there by 20% every 2 years.

c. **<u>Turning on and off (and on) grantor trust status: Clauses/methods</u>**: I prefer to use multiple methods to ensure grantor trust status, such as:

(i) Including the grantor's spouse as a beneficiary (IRC Section 677), which also provides flexibility to reach the assets.

(ii) Giving the grantor (or another party in a nonfiduciary capacity) the power to substitute property of equivalent value.

(iii) Power of the trustee to use trust income to pay premiums of insurance on the grantor's life and to lend to the grantor without adequate security.

(iv) Appointing a non-adverse party as trustee who has the power to affect beneficial enjoyment (generally not limited by ascertainable standards and with *more* than half of the trustees related or subordinate to the grantor, unless the trustee has the power to add beneficiaries).

d. **<u>Toggling</u>**: Build in clauses that expressly allow the trustee to release his or her powers that cause grantor trust status, and include clauses that release and indemnify the trustee from any liability for doing so. After all, why would it be in the interests of the beneficiaries to require the trust to pay its own taxes? Also give the grantor (or other party) the power to release the power to substitute assets of equivalent value, and to change the trustees so that section 674 does not apply (adverse parties as trustees, or less than a majority being related/subordinate). If there are "trust protectors" who can change trust terms and affect beneficial enjoyment, they might need to be changed or release their powers.

The simplest way to turn grantor trust back "on": Use section 674 and reappoint trustees who are related or subordinate to the grantor (at least half or else with power to add beneficiaries) who can control beneficial enjoyment.

Of course, be cognizant of income tax consequences of turning off grantor trust status, such as triggering gain if the trust's liabilities exceed its basis in the trust assets, or if the trust owns a partnership and the trust's pro rata share of partnership liabilities exceeds the partnership's basis in its assets.

e. **<u>Tax Reimbursement</u>**: Give an unrelated/non subordinate trustee the discretionary power to reimburse the grantor for the income tax attributable to the trust, as permitted under Rev. Rul. 2004-64; 2004-27 IRB 7, Jul. 6, 2004. However, before using this clause, check applicable state law to determine whether this provision will cause any of the trust property to be reachable by the grantor's creditors, or this provision could cause estate inclusion. In any event, this is limited to taxes attributable only to the immediately preceding calendar year to limit the total amount that is potentially distributable to the grantor (as such amount could be reached by the Grantor's creditors depending on state law). Based on the revenue ruling, unless the IRS can show an implied or express agreement or understand that the trustee *will* reimburse the grantor, this provision won't cause estate inclusion under Section 2036.

<u>Sample language:</u>

I hereby waive any right of reimbursement under any applicable law for my tax liability (whether federal, state or otherwise), if any, attributable to a trust being treated as a "grantor trust" as to me under Code Sections 671 through 679. If (i) in any calendar through 679 and (ii) Revenue Ruling 2004-64 has not been modified, revoked or withdrawn and may be relied upon as precedent in the jurisdiction in which the trust is modified, revoked or withdrawn if other binding precedent then exists that reaches the same holding as currently set forth in Revenue Ruling 2004-64 for situation 3), the trustee may, in the trustee's discretion, pay directly to the taxing authorities or reimburse me out of the trust property such amount equal to the amount by which my Federal, state taxes that would have been imposed if the trust's income, gains, losses and deductions had not been included in the determination of my income tax liability (the "Incremental Taxes"); provided, however, the trustee shall have no discretion to pay directly to the taxing authorities or reimburse me out of the trust property any amount pursuant to this Section if such discretion, combined with any applicable state law which would subject the trust property to the claims of *my* creditors, would cause inclusion of the trust property in my gross estate for federal or state estate tax purposes. If it is finally determined for income tax purposes that the trustee reimbursed me an amount in excess of the Incremental Taxes, I shall repay such trust such excess amount within thirty (30) days of the final determination of the Incremental Taxes. It is intended that the trustee's exercise of discretion to reimburse me for any such income taxes not be considered a gift from the trust beneficiaries to me and that the existence of such power shall not be considered a retained right or interest that will cause inclusion of any part of any trust created hereunder in my estate for federal and state estate tax purposes; this Section and this Agreement shall be construed in accordance with this stated intent. Notwithstanding any other provision of this Agreement, only a trustee who is not related or subordinate to me within the meaning of Section 672(c) of the Code, may exercise the powers to reimburse me granted to the trustee pursuant to this Section. This provision supersedes any otherwise applicable provision of law governing payment or reimbursement of my taxes, including any right I would otherwise have to such payment or reimbursement.

15. Funding Charitable and Non-Charitable Distributions at 2nd death:

It sounds simple enough when a married couple wants to make bequests to various friends, family and charities at the second spouse's death. The difficulty is that one doesn't know where the assets will be at the surviving spouse's death. They could be in the survivor's revocable trust and/or a credit shelter trust or marital trust created under the predeceased spouse's revocable trust. Further, there could be multiple marital trusts and credit shelter trusts, some GST exempt, some not, some for which a state QTIP election was made or both a federal and state QTIP election.

It is critical to specify from which sources each bequest may or *must* be made to maximize the tax benefits and minimize current estate taxes, and to avoid paying the bequests multiple times from different sources. For example, one might want the GST exempt assets to pass to the children and grandchildren rather than friends. In the case of charitable gifts, the trusts must *require* that they be paid from assets included in the surviving spouse's estate (e.g., his/her revocable trust or marital trusts included in the spouse's estate), or the estate tax charitable deduction might be partly or completely denied.

One can obtain an estate tax charitable deduction for property included in his or her estate that passes to charity. That determination is made as of the time of death. For example, if the revocable trusts provide that $1 million is to be distributed to charity from the survivor's revocable trust, the marital trust and/or the credit shelter trust, it is uncertain, as of the time of death, whether that $1 million will be paid from assets included in the estate (revocable trust and marital trust), or from assets not included (the credit shelter trust). If the credit shelter trust has more than $1 million and it is therefore possible that the entire distribution might come from that trust, the estate is *not* entitled to a charitable deduction.

So, it is important to have provisions that coordinate among the revocable trust, marital trusts and credit shelter trusts to (a) pay the bequests only once in the aggregate, (2) pay the charitable bequests only out of assets included in the estate (and preferably from non-GST exempt assets) and (3) indicate who should receive or benefit from the GST exempt assets.

Finally, sometimes the goal is to have bequests to individuals/trusts with the residue to charity, *and* for the charitable residue to bear all the taxes. However, if the charitable amounts primarily come from a QTIP marital trust, there will be no right of recovery under Section 2207A! That section only allows recovery of the incremental estate tax caused by the marital trust, and if it all goes to charity, that will be $0. In the case of a GPA marital trust, the right of recovery is still limited to the size of the marital trust relative to the rest of the taxable estate. In this case, one needs to use a GPA marital and have the surviving spouse exercise the GPA in favor of his or her estate or revocable trust.

16. **Favorite Boilerplate Clauses**

c. **Special Needs Trusts**: Give the trustee the power to convert a trust into a "supplement needs" or "special needs" trust so that a beneficiary can continue to qualify for Medicaid, Social Security disability, or other government benefits. The clause below also allows conversion back if the trustee determines the beneficiary would be better off foregoing government benefits.

Sample language:

> To convert a beneficiary's interest to a "supplemental needs interest" (as hereinafter defined) that would allow the trust (with respect to that beneficiary) to qualify as a trust for a disabled beneficiary under applicable law or to qualify as a "qualified disability trust" (as defined in Section 642 of the Code) if the conversion is necessary for the beneficiary to qualify for benefits from a federal, state or local government or agency thereof and the conversion is in the beneficiary's best interests. The amendment implementing a conversion to a supplemental needs interest may provide for the possibility that the beneficiary's interest may be converted back to its original form hereunder if such a reconversion would be in the beneficiary's best interests.

d. **<u>Incapacity definition</u>**: For trustees, beneficiaries or others.

<u>Sample language</u>:

For purposes of this Agreement, a person shall be considered "Incapacitated" if (i) such person is a minor or is under a legal disability (under the laws of such person's domicile); (ii) such person is incarcerated and such incarceration has lasted for more than thirty (30) consecutive days; (iii) such person's whereabouts are unknown and either a "Qualified Beneficiary" of the trust or the trustee of the trust has not been able to locate him for at least ninety (90) days; (iv) a licensed physician, within six (6) months after examining such person, signs a letter stating that such examination has occurred and that such person, due to illness or physical, mental or emotional disability, is not able to manage business affairs in a prudent and intelligent manner, and such person shall be considered Incapacitated upon the date such letter is signed; or (v) such person fails to produce a "Qualifying Letter" within ninety (90) days after a written request is made by a "Qualified Beneficiary" or trustee of the trust; provided, however, no person shall be required to produce a Qualifying Letter more than once during any one year period. A "Qualifying Letter" shall mean a letter signed by a licensed physician after examining a person, which examination shall have occurred no more than six (6) months prior to the date of the request, stating that such examination has occurred and that such person is able to manage business affairs in a prudent and intelligent manner. A "Qualified Beneficiary" shall mean a person (A) to whom the trustee is directed or authorized to currently distribute net income and/or principal (a "current beneficiary"), or (B) who, upon a certain event, will receive, or who will be a current beneficiary of a trust that will receive, all or a portion of the trust property, assuming nonexercise of all powers of appointment and assuming that such person survives until the event. If a person has been considered "Incapacitated" pursuant to this provision but subsequently provides a Qualifying Letter to the trustee, such person shall no longer be considered Incapacitated.

e. **<u>Divorce clause in irrevocable trusts</u>**: What should a divorce clause say, especially when one represents both spouses? Put the spouses on equal footing, eliminating both as beneficiaries allowing them to appoint and remove trustees together? Or does the "moneyed spouse" have greater rights, able to appoint trustees without the other? Are all other extended family members of one spouse removed as trustees and beneficiaries?

<u>Sample language</u>:

In the event I file or my spouse files a petition for legal separation or dissolution of marriage, my spouse, my spouse's parents, all descendants of my spouse's parents who are not my descendants and all spouses of such persons who are not descendants of my parents shall be deemed to have died intestate on the date of such filing for all purposes of this Agreement (other than for purposes of the Section titled "Rule Against Perpetuities") and (i) any exercises of powers of appointment by such persons that have not become effective prior to the date of such filing shall be null and void and (ii) all

Plans created by such persons in their individual, fiduciary and representative capacities shall be null and void; provided, however, that if court order(s) are issued dismissing all such petitions (whether filed by me or my spouse) and I accept the dismissal of such petitions filed by my spouse by a signed instrument, then all such persons shall no longer be deemed to have died intestate for all purposes of this Agreement and (i) any exercises of powers of appointment by such persons that were not effective prior to the filing of such petitions shall no longer be null and void, and (ii) all Plans created prior to the filing of such petitions by such persons in their individual, fiduciary and representative capacities shall no longer be null and void.

<u>Second version</u>:

In the event I file or my spouse files a petition for legal separation or dissolution of marriage:

i. my spouse shall no longer be a beneficiary of any trust hereunder and any exercises of powers of appointment by my spouse that have not become effective prior to the date of such filing shall be null and void;

ii. my spouse may continue to serve as a trustee of any trust hereunder (if designated as such), and retain any powers my spouse may have to create plans of trustees and to remove trustees; and

iii. my spouse's parents, all descendants of my spouse's parents who are not my descendants and all spouses of such persons who are not descendants of my parents ("my spouse's family") shall be deemed to have died intestate on the date of such filing for all purposes of this Agreement (other than for purposes of the Section titled "Rule Against Perpetuities" and "Ultimate Contingent Beneficiaries") and (i) any exercises of powers of appointment by my spouse's family that have not become effective prior to the date of such filing shall be null and void and (ii) all plans created by my spouse's family in their individual, fiduciary and representative capacities shall be null and void;

provided, however, that if court order(s) are issued dismissing all such petitions (whether filed by me or my spouse) and I accept the dismissal of such petitions filed by my spouse by a signed instrument, then (i) my spouse shall continue to be a beneficiary of any trust hereunder that names my spouse as a beneficiary, (ii) no member of my spouse's family shall be deemed (pursuant to the foregoing provisions of this subsection to have died intestate for any purposes of this Agreement, and (iii) any exercise of power of appointment by my spouse or a member of my spouse's family that was not effective prior to the filing of such petitions shall no longer be null and void, and (iv) any plan created prior to the filing of such petitions by a member of my spouse's family in their individual, fiduciary and representative capacities shall no longer be null and void.

f. **<u>Single signatory</u>**: Give each trustee the power to sign documents on behalf of all trustees, assuming they have approved of such action.

<u>Sample language</u>:

Unless a co-fiduciary elects otherwise in writing, any one co-fiduciary may sign any checks, agreements or other documents on behalf of the trust and such signature shall bind the trust in the same manner as though said check, agreement or other document had been signed by all of the co-fiduciaries acting in the same capacity, and no person or entity dealing with the signing fiduciary shall be obliged to inquire as to the other co-fiduciary's acquiescence to such action.

g. **Survivorship Clause: 90 days**: Including a 90-day survival requirements expands possible use of the GST predeceased parent exception.

(i) Predeceased parent exception: Section 2651(e) of the Code provides an exception to the generation-skipping tax for a direct skip, taxable distribution or taxable termination to a person who is a descendant of a parent of the transferor (or a descendant of a parent of the transferor's spouse or former spouse), if the parent of the recipient who is a descendant of a parent of the transferor (or the transferor's spouse or former spouse) was not living at the time of the original transfer by the transferor. For example, if a gift is made to a lineal grandchild, and at the time of the direct skip the parent of the grandchild who is a descendant of the transferor (i.e., the transferor's child) is not living, then the grandchild "moves up" one generation for GST purposes, and as a result no direct skip results.

However, for this exception to apply to taxable distributions and taxable terminations, the skip person must have moved up a generation at the time of the original transfer to the trust; moving up a generation subsequent to that time is insufficient even if it occurs before the taxable distribution or taxable termination.

(ii) GST 90 day rule: Under Reg. Section 26.2651-1(a)(2)(iv), a person who dies within 90 days of the transfer is treated as having predeceased the transferor *for GST purposes* to the extent that the governing instrument or local law provides that such person is to be treated as having predeceased the transferor. Therefore, if a trust included in a parent's estate provides for a distribution to the parent's child if he survives the parent for 90 days, otherwise to the child's descendants on a per stirpital basis, then if the child in fact dies within 90 days of the parent, the child will be treated as if he predeceased the parent and the predeceased parent exception will apply to eliminate the direct skip.

Sample language:

Survivorship of Beneficiaries. Notwithstanding any provision of this Agreement, any distribution to be made upon my death from any portion of the property of the Gift Trust that is included in my gross estate to or for the benefit of any person other than Jane shall be contingent on the intended recipient surviving me for at least 90 days. If such intended recipient does not survive me for at least 90 days, then the distribution to be made to or for the benefit of such intended recipient shall instead be distributed as if such intended recipient predeceased me.

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