Estate Planning for Income Tax Reduction: Strategies for Maximizing New Basis

Leveraging Estate Tax Inclusion, Partnerships, Trusts, and Powers of Appointment

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The Optimal Basis Increase and Income Tax Efficiency Trust

Exploiting Opportunities to Maximize Basis, Lessen Income Taxes and Improve Asset Protection for Married Couples after ATRA (or: why you’ll learn to love the Delaware Tax Trap)

(this version updated April 2016)

By Edwin P. Morrow III, J.D., LL.M. (tax)

I. Problems with Traditional AB Trust Design & the Lure of Portability
   a. Responding to the portability threat – and opportunity
   b. What’s “wrong” with the traditional AB trust post-ATRA
   c. Thirteen reasons not to “skip the trust”

II. Using Marital Trusts – not as simple a solution as you think
   a. Clayton QTIP v. disclaimer funded trusts
   b. Variations of marital trusts - GPOA marital v. QTIP marital
   c. The weak threat (and nifty loopholes) of Rev. Proc. 2001-38 for QTIPs
   d. The valuation advantage (for <1%), and pitfall (for >99%) of QTIPs
   e. How to adapt QTIPs for better “step up”
   f. Summarizing benefits and drawbacks endemic to all marital trusts
   g. Techniques to adapt ordinary bypass trusts to increase basis
   h. Are trust protector powers to add GPOAs dangerous?

III. Why Optimal Basis Increase Trusts (OBITs) are Superior to AB Trusts
   a. Introducing targeted General Power of Appointment (GPOA) concepts
   b. Comparison of formula GPOA v. QTIP v. bypass trusts
   c. Capping the GPOA to avoid state and/or federal estate tax
   d. Determining the appointive assets when the GPOA is capped
   e. Issues if spouse is sole trustee or investment advisor
   f. Application to states with a separate estate or inheritance tax
   g. Drafting GPOAs to keep fidelity to the estate plan and asset protection
   h. Testamentary GPOAs - subject to power holder’s estate’s creditors/spouse?
   i. Exploiting the Delaware tax trap, §2041(a)(3), to augment basis
   j. Drafting alternatives to curb the “PEG Power” yet still trigger §2041(a)(3)
   k. Curbing or crafting Delaware tax trap savings clauses
   l. Addressing concerns of potential attacks on formula GPOAs
   m. PLRs 9110054, 9527024– formula GPOAs based on powerholder’s estate
   n. Analyzing and addressing the Kurz cases
   o. Comparing use of LPOAs & Delaware tax trap v. use of formula GPOAs

IV. Busting Disclaimer Myths – Using OBITs w/ Disclaimer Based Planning
   a. How a spouse can retain LPOAs/GPOAs in trusts post-disclaimer
   b. Keeping testamentary powers post-disclaimer in QTIPs – Lassiter case
   c. How OBITs open up better post-mortem disclaimer planning at 2nd death

1 Portions of this outline were presented at various CLEs 2011-2016 and were published in Trusts and Estates, Leimberg LISI Estate Planning Newsletter or CCH Estate Planning Review. © 2011-2016 Edwin P. Morrow III – Contact: edwin_p_morrow@keybank.com, or edwin.morrow3@gmail.com. See this website for further updates and cite paper to this address: http://ssrn.com/abstract=2436964 or http://dx.doi.org/10.2139/ssrn.2436964
V. Doubling or Increasing the Basis Step Up at First or Other Deaths.................71
   a. Transmutation agreements and community property agreements............... 71
   b. Alaska/Tennessee community property trusts........................................ 72
   c. The overlooked fractional interest dilemma of community property........... 74
   d. Joint GPOA or Joint Exemption Step up Trusts (“JESTs”)........................ 75
   e. Marital Deduction under §2523 for Gifts to Spouse Complete at Death...... 76
   f. Into the Wind of §1014(e) – Tacking to Increase Basis Despite 1 yr rule.... 77
   g. The “Estate Trust” as alternative ...................................................... 84
   h. “Naked” GPOAs, Crummey OBITs and Upstream basis planning............... 87
   i. The Upstream Crummey Optimal Basis Increase Trust............................ 88
   j. Building on the JEST concept by adapting irrevocable spousal OBITs...... 103
   k. Using irrevocable OBITs to protect the basis of “loss” assets............... 105
   l. The “Can’t BDIT” - ensuring step up at settlor/parent’s death.............. 107

VI. Asset Protection Strategies Opened Up by Increased Exclusion......................111
   a. SLATs or other trusts with OBIT clauses and potential reversions.......... 112
   b. Adapting ILITs...................................................................................... 113

VII. Application of OBIT Techniques to Existing Irrevocable Trusts..................114
   a. Using existing LPOAs to trigger §2041(a)(3) for basis increase........... 114
   b. Prospective tax effect of amending irrev. trusts prior to power holder’s death...115
   c. Limiting amendments to keep fidelity to settlor’s intent.................... 117
   d. Gift tax effect of beneficiary procurement/consent to amendment........ 118
   e. Asset protection effect of beneficiary procurement/consent to amendment.122
   f. Amendments or modifications affecting GST exemption...................... 122
   g. Substantial amendments causing a taxable exchange under §1001............ 123
   h. Decanting in net income/HEMS trusts without absolute discretion........ 128
   i. Dangers of “self-help” terminations in lieu of following state law......... 129

VIII. Ongoing Income & Surtax Planning for Irrevocable Non-Grantor Trust........132
   a. Changes to Trust Income Taxation Wrought by ATRA and ACA............. 133
   b. IRC §678(a) – Using Mallinckrodt/beneficiary-defective grantor trusts.... 138
   c. IRC §678(a) – Seizing the $250,000 capital gains tax exclusion under §121...148
   d. IRC §678(a) – Application to special needs trusts......................... 150
   e. IRC §678(a) – Application to QTIP trusts........................................ 150
   f. IRC §678(a) - Transactions between beneficiaries and fully §678(a) trusts...151
   g. Using §1.643(a)-3 regs to permit capital gains to pass out w/DNI on K-1... 151
   h. Comparing the three methods under §1.643(a)-3(b).............................. 155
   i. Problems with adapting irrevocable trusts with prior tax reporting history.156
   j. Impact of changing the capital gains tax burden on distributions........ 157
   k. Using lifetime limited powers of appointment to spray income............. 158
   l. QTIPs are (probably) terrible for tax shifting - what can be done (maybe)... 159
   m. IRC §642(c) – Seizing above the line charitable deductions in trusts....... 162
   n. DINGs, NINGs, OINGs – not just for state income tax avoidance.......... 168
   o. The DING-CRUT – federal tax deferral plus state income tax avoidance.... 170

IX. Summary..................................................................................................172

X. Appendix (sample clauses, forms, comparison charts and infographics)......A-1
Part I – New Problems with Traditional AB Trust Design and Adapting to Portability

“It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change.” – Charles Darwin

For many taxpayers, the traditional trust design for married couples is now obsolete. This article will explore better planning methods to maximize basis increase for married couples (and, for future generations), exploit the newly permanent “portability” provisions, maximize adaptability to future tax law, enable better long-term income tax savings and improve asset protection over standard “I love you Wills” and over standard AB trust planning. Primarily, this article focuses on planning for married couples whose estates are under $10.5 million, but many of the concepts apply to those with larger estates as well.

First, we’ll describe the main income tax problems with the current design of most trusts in light of portability and the new tax environment – and problems with more simplified “outright” estate plans. In Part II, we’ll describe potential solutions to the basis issue, including the use of various marital trusts (and the key differences between them), and why these may also be inadequate. In Part III, we’ll explore how general and limited powers of appointment and the Delaware Tax Trap can achieve better tax basis adjustments than either outright bequests or typical marital or bypass trust planning. I will refer to any trust using these techniques as an Optimal Basis Increase Trust (“OBIT”). In Part IV, we will discuss how these techniques accommodate disclaimer based planning (or disclaimers from lack of planning). Part V discusses various techniques to achieve a step up in basis at an older relative’s death, or that of the first spouse to die. Part VI posits new asset protection opportunities. Part VII explores the tremendous value of applying OBIT techniques to pre-existing irrevocable trusts. Lastly, in Part VIII, we’ll discuss various methods to ensure better ongoing income tax treatment of irrevocable trusts – not just neutralizing the negatives of trust income taxation, but exploiting loopholes and efficiencies unavailable to individuals. I will refer to these two groups of techniques taken together as an Optimal Basis Increase and Income Tax Efficiency Trust, features of which are summarized in the charts in the appendix.²

² No trademark claimed, “Super-Duper Charged Credit Shelter Trust” was apparently unavailable. Attorneys have adopted many names for basis optimizing: “basis harvesting trust”, “basis protection trust”, “optimal benefit trust”
a. **Responding to the Portability Threat -- and Opportunity**

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Act") introduced a profound change to estate planning that was recently confirmed by the American Taxpayer Relief Act of 2012 ("ATRA"). Section 303 of the 2010 Tax Act, entitled “Applicable Exclusion Amount Increased by Unused Exclusion Amount of Deceased Spouse”, is commonly known as “portability”.3 ATRA recently made this provision permanent, along with a $5,000,000 exemption for estate, gift and generation skipping transfer tax, adjusted for inflation (even with low inflation, it has already increased to $5,250,000).4

The concept of portability is simple: the surviving spouse gets any unused estate tax exclusion of the deceased spouse provided the Form 706 is properly filed. While it does have various flaws and quirks, portability goes quite far to correct a basic injustice that would otherwise occur when the beneficiaries of a couple with no bypass trust planning pay hundreds of thousands (if not millions) more in estate tax than the beneficiaries of a couple with the same assets who die without any trust planning.

Portability has been described as both the “death knell” of the AB Trust5 as well as a “fraud upon the public”.6 Ubiquitous popular financial press articles now refer to the “dangers” of traditional AB trust planning or the “death of the bypass trust”. While these charges have some surface justification, they all fail to see the tremendous income tax and asset protection opportunities opened up to such trusts by the new law – if trusts are properly adapted.

The lure of portability and a large exemption is indeed a siren song for some married taxpayers to avoid trusts. Like Odysseus, we should listen to it despite of our misgivings. The new exemption level, coupled with the advantages of portability, eliminates what was

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3 Section 303 of Public Law 111-312, known as the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010
4 Rev. Proc. 2013-15 – it will increase to $5.34 million in 2014
5 E.g. “AB Trust can be hazardous to your health”, “Serious tax consequences to AB Trust owners” “Portability Threatens Estate Planning Bar”, “Is it time to bypass the bypass trust for good?” , and dozens more
6 Frequent Trusts and Estates author Clary Redd at May 2011 Advanced Trust Planning CLE, Dayton, Ohio - to be fair, he made this comment before the provision was made permanent.
previously the most easily quantifiable reasons to do trust planning – saving estate tax - for the vast majority of taxpayers. More than that, however, the new tax environment seemingly deters taxpayers from using trusts through significant income tax disparities, despite the many non-tax reasons for using them.

b. What’s “wrong” with the traditional AB trust post-ATRA?

1) No Second “Step Up” in Basis for the Bypass Trust Assets for the Next Generation.
Imagine John leaves his wife Jane $3 million in a bypass trust and Jane outlives him 10 years. Over that time the income is spent but the fair market value has doubled to $6 million. Jane has her own $3 million in assets. At Jane’s death, their children inherit assets in the bypass trust with only $3.5 million in basis. Had John left his assets to her outright or to a differently designed trust and Jane elected to use her Deceased Spousal Unused Exclusion Amount (DSUEA), heirs would receive a new step up in basis to $6 million, potentially saving them $750,000 or more.7

2) Higher Ongoing Income Tax. Any income trapped in a typical bypass or marital trust over $11,950 is probably taxed at rates higher than the beneficiary’s, unless the beneficiary makes over $400,000 ($450,000 married filing jointly) taxable income. Including the new Medicare surtax, this might be 43.4% for short-term capital gains and ordinary income and 23.8% for long-term capital gains and qualified dividends. This is a staggering differential for even an upper-middle class beneficiary who might be subject to only 28% and 15% rates respectively.

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7 Of the $3 million original basis, this assumes $500,000 is added due to income or gain realized over time (increasing basis), over the loss in basis due to depreciation or realized losses (which decrease basis), creating $2.5 million unrealized gain times a hypothetical 30% combined federal (23.8%) and state (net 6.2%) long term capital gains tax – this may be higher if you consider 28% rate for collectibles, or if the assets were depreciable property, one might look at the depreciation lost and the ordinary income that could have been offset by the extra basis, which might drive this estimated loss to beneficiaries even higher (though you would have to back out for present value). Of course, if heirs never sell the property (and depreciation does not apply) and hold until death, losses resulting from decreased basis would be non-existent. In short, it’s a rough “guesstimate”. As discussed later herein, some assets do not receive a new basis even if in the decedent’s estate, some assets receive a basis not based on the fair market value at date of death or under an alternate valuation date. IRC §§691(c), 1014, 2032, 2032A, and some receive de facto step up (Roth IRA, life insurance)
3) **Special assets can cause greater tax burden in trust.** Assets such as IRAs, qualified plans, deferred compensation, annuities, principal residences, depreciable business property, qualifying small business stock and S corporations are more problematic and may get better income tax treatment left outright to a surviving spouse or to a specially designed trust. Retirement plan assets left outright to a spouse are eligible for longer income tax deferral than assets left in a bypass trust, even if trust makes it through the gauntlet of “see-through trust” rules and the minefield of planning and funding trusts with “IRD” (income in respect of a decedent) assets.8 Other assets, such as a personal residence, have special capital gains tax exclusions or loss provisions if owned outright or in a grantor trust.9 Ownership of certain businesses requires special provisions in the trust that are sometimes overlooked in the drafting, post-mortem administration and/or election stages.10

Yet outright bequests are not nearly as advantageous as using a trust, and there are various techniques discussed herein to avoid these three negatives. The best planning should probably utilize an ongoing trust as well as exploit portability, which will be discussed in the next section.

c. **Why not just skip the burdens of an ongoing trust?**11 Here’s a quick baker’s dozen:

1) A trust allows the grantor to make certain that the assets are managed and distributed according to his/her wishes, keeping funds “in the family bloodline”. Sure, spouses can agree not to disinherit the first decedent’s family, but it happens all the time – people

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8 For a checklist of reasons why to use a trust and drafting and administration issues to consider if you do name a trust as beneficiary, email the author for separate CLE outline, comprehensive checklist and related articles. Also, see Sal LaMendola’s excellent comparison of IRA/trust options for second marriage situations in *Estate Planning for Retirement Plan Owners in Second (or Later) Marriages* - [http://www.michbar.org/probate/pdfs/summer13.pdf](http://www.michbar.org/probate/pdfs/summer13.pdf)
9 IRC §121, discussed further in Part VIII of this outline
10 For S Corp qualification, including QSST and ESBT, see IRC §1361 et seq., for small business stock exclusion and rollovers, see IRC §1202 and §1045, for losses on qualifying small business stock, see IRC §1244
11 I will avoid the probate/non-probate revocable trust v. will debate, since probate costs and fees will vary from state to state. A bypass or marital trust might be a testamentary trust under a will.
move away, get sick and get remarried – the more time passes, the more the likelihood of a surviving spouse remarrying or changing his or her testamentary disposition.\textsuperscript{12}

2) Unlike a trust, assets distributed outright have \textbf{no asset protection from outside creditors} (unless, like an IRA or qualified plan, the asset is protected in the hands of the new owner) - whereas a bypass trust is ordinarily well-protected from creditors;

3) Unlike a trust, assets distributed outright have \textbf{no asset protection from subsequent spouses when the surviving spouse remarries}. Property might be transmuted or commingled to become marital/community property with new spouse. If it is a 401(k) or other ERISA plan, it might be subject to spousal protections for the new spouse (which cannot be cured via prenup, and become mandatory after a year of marriage).\textsuperscript{13} Most states also have spousal support statutes which require a spouse to support the other - and there is no distinction if it is a second, third or later marriage. Also, most states have some form of spousal elective share statutes that could prevent a surviving spouse from leaving assets to children to the complete exclusion of a new spouse;\textsuperscript{14}

4) Unlike a trust, assets left outright \textbf{save no STATE estate or inheritance tax} unless a state amends its estate tax system to allow similar DSUEA elections (don’t hold your breath – none have yet). This savings would be greater in states with higher exemptions and higher rates of tax, such as Washington State (20% top rate) or Vermont (16% top tax rate), both with $2 million exemptions. Assuming growth from $2 million to $3 million and a 16% state estate tax rate, that savings would be nearly $500,000!

\textsuperscript{12} A contract to make a will may offer a tempting solution, but there are significant problems with those that exceed the scope of this paper, such as triggering a prohibited transaction or violating the exclusive benefits rule as to retirement plan assets or disqualifying assets from marital deduction, not to mention significant practical enforcement complexities

\textsuperscript{13} See the \textit{Retirement Equity Act of 1984}, IRC §401(a)(11), IRC §417(d)(1), Treas. Reg. §1.401(a)-20, Q&A 28 – but beware - many retirement plan documents vest the spouse \textit{before} the one year required by statute. This can be waived \textit{after} marriage, but most courts follow Treas. Reg. §1.401(a)-20, holding a waiver in a prenup to be invalid

\textsuperscript{14} See, e.g., Uniform Probate Code §2-201 et seq.
5) Unlike a bypass trust, income from assets left outright cannot be “sprayed” to beneficiaries in lower tax brackets, which gets around gift tax but more importantly for most families can lower overall family income tax – remember, the 0% tax rate on qualified dividends and long-term capital gains is still around for lower income taxpayers!

6) The Deceased Spousal Unused Exclusion Amount (DSUEA), once set, is not indexed for inflation, whereas the Basic Exclusion Amount (the $5 million) is so adjusted after 2011 ($5.25 million in 2013). The growth in a bypass trust remains outside the surviving spouse's estate. This difference can matter tremendously where the combined assets approximate $10.5 million and the surviving spouse outlives the decedent by many years, especially if inflation increases and/or the portfolio achieves good investment returns;

7) The DSUEA from the first deceased spouse is lost if the surviving spouse remarry and survives his/her next spouse's death (even if last deceased spouse’s estate had no unused amount and/or made no election). This result, conceivably costing heirs $2.1 million or more in tax, restrains remarriage and there is no practical way to use a prenuptial (or postnuptial) agreement to get around it;\(^{15}\)

8) There is no DSUEA or “portability” of the GST exemption. A couple using a bypass trust can exempt $10.5 million or more from estate/GST forever, a couple relying on portability alone can only exploit the surviving spouse’s $5.25 million GST exclusion. This is more important when there are fewer children, and especially when these fewer children are successful (or marry successfully) in their own right. For example, a couple has a $10.5 million estate and leaves everything outright to each other (using DSUEA), then to a trust for an only child. Half will go to a GST non-exempt trust (usually with a general power of appointment), which can lead to an additional $5.25 million added to

\(^{15}\) This is not to say that prenuptial agreements should not address DSUE and portability – they should. See Karibianian and Law, Portability and Prenuptials: A Plethora of Preventative, Progressive and Precautionary Provisions, 53 Tax Management Memorandum 443 (12/3/12)
that child’s estate – perhaps needlessly incurring more than $2 million in additional estate tax.

9) Unlike a bypass trust, **portability requires the executor to timely and properly file an estate tax return** to exploit the exclusion, and is irrevocable once elected.\(^\text{16}\) This may require opening a probate simply to appoint an executor.\(^\text{17}\) This is easy for non-professional executor/trustees to overlook. The IRS is not authorized to grant exceptions or extensions for reasonable cause, though it is still open whether 9100 relief might be available if the estate value was under the threshold filing requirement (e.g. gross estate under $5.25 million);

10) Unlike a bypass trust, outright bequests cannot be structured to better accommodate incapacity or government benefits (e.g. Medicaid) eligibility planning;\(^\text{18}\)

11) A **bypass trust can exploit the serial marriage loophole**. Example: John Doe dies leaving his wife Jane $5.25 million in a bypass trust. She remarries and with gift-splitting can now gift $10.5 million tax-free. If husband #2 dies using no exclusion – Jane can make the DSUEA election and have up to $10.5 million Applicable Exclusion Amount (AEA), even with the $5.25 million in the bypass trust John left her, **sheltering over $15.75 million** (three exclusion amounts, not adjusting for inflation increases) for their children without any complex planning, not even counting growth/inflation. Had John left his estate to Jane outright or in marital trust, even w/DSUEA, their combined AEA would be capped at two exclusion amounts ($10.5 million, not adjusting for inflation increases) – a potential loss of over $2 million in estate tax.\(^\text{19}\)

\(^{16}\) IRC §2010(c)(5); Treas. Temp. Reg. §20.2010-2T(a)

\(^{17}\) If there is no executor, those in possession may file, but that may be a mess for many reasons. IRC §2203. Co-executors must ALL sign the return and agree to election or it is not valid. Treas. Reg. §20.6018-2

\(^{18}\) Strangely enough, there may be a difference here between a testamentary and living trust. See 42 U.S.C. § 1396p(d)(6); HCFA Transmittal 64 § 3259.1(A)(1)

\(^{19}\) It appears from new regulations that DSEU has its own serial marriage loophole, though. If John left assets outright to Jane and she then gifts $5.25 million after John dies, she retains her own $5.25 exclusion, and when Husband #2 dies, she can gift another $5.25 million while retaining her own exclusion, ad infinitum.
12) Portability only helps when there is a surviving spouse. It may not work in a simultaneous death situation, whereas a bypass trust with proper funding or a simultaneous death clause imputing John as the first to die and Jane as survivor would.  

Example: John has $8 million in assets, Jane $2.5 million. There is no community property. John believes the popular press and thinks he can rely on portability and the DSUEA to kick in and shelter their $10.5 million. But, John and Jane are in a tragic accident together. *Neither John nor Jane has a surviving spouse.* John’s estate cannot elect to use $2.75 million of Jane’s wasted Basic Exclusion Amount and now their family needlessly pays a tax on John’s estate of $1,100,000 ($2.75 million x 40%).

13) Tax Apportionment under §2207A and state law shafts the first to die’s children when relying on portability.

Example: John has $10.25 million, Jane has $10.25 million. John dies, leaving assets in a QTIP for Jane to “get a second step up”, believing his kids are assured equal treatment and protection via QTIP, thus $5.25 million DSUE is ported. Jane dies with $10.5 million applicable exclusion amount (AEA), but a $20.5 million estate. This causes approximately $4 million estate tax due (or much more, depending on the state). *Guess whose kids pay all the tax?* That’s right – John, the first to die’s, kids (through John’s QTIP) pay ALL of the federal estate tax (and probably much more of any state estate tax, depending on the state), not half or pro-rata as some may expect.  

Jane’s kids, through her estate, pay none, unless she specifically overrides the state and federal apportionment statutes in her Will/trust.

14) Bonus – The surviving spouse’s new spouse can waste all the DSUE if the surviving spouse agrees to gift split. Example: John leaves $5.25 million to QTIP for wife Mary, who remarries and her new wealthy husband convinces her to split his gift.

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20 See Treas. Reg. §20.2056(c)-2(e) – had John’s will/trust had an A/B split or QTIPable trust with a simultaneous death clause stating that Jane is deemed to have survived him that would have probably overridden state law defaults and the IRS would respect the marital trust and hence add enough assets to Jane’s estate to use both exemptions (including GST). State laws may differ on this point but many have passed the Uniform Simultaneous Death Act. When the order of death can be determined, you cannot simply change the order in the Will/Trust for “surviving spouse” purposes. See Estate of Lee v. Commissioner, T.C. Memo 2007-371. If we include a presumption that Jane dies first, will the IRS respect John as a “surviving spouse” for purposes of DSUEA? Probably, but we have no guidance yet – temporary regs do not mention this issue. Note – I have not verified whether this issue is addressed in final regulations issued in 2013 after this was written.

21 IRC §2207A, see § 2207 for marital GPOA; for an example of state law equivalent, see Ohio R.C. 2113.86(1)
Part II - Using Marital Deduction Trusts and Other Options to Avoid Basis Stagnation

“Primum, non nocere.” First, do no harm. – dictate from physician’s Hippocratic Oath

There are other alternatives that get us closer to preserving the best basis increase and income tax result for the family. First, let’s consider variations to enable/disable or limit funding of marital trusts to maximize post-mortem flexibility, then explore the variations of marital deduction trusts. Remember that a marital deduction trust, even when it would not be needed to reduce estate tax, does have the advantage of a second step up in basis at the surviving spouse’s death.

a. Thinking Outside the “Outright v. Bypass Trust” Box: Clayton QTIP v. Disclaimer

Of course, simple outright gifts and traditional bypass trust planning are not the only two options – and they need not be “all or nothing”. Disclaimer funded bypass trusts allow the surviving spouse to choose how much is allocated between those two (or more) options. The chief disadvantage of disclaimer planning is that it usually prohibits the surviving spouse from using powers of appointment for greater flexibility (see Part IV) and requires timely and proactive analysis and action (and, just as importantly, restraint) immediately after the death of a loved one. As discussed further herein, this loss in flexibility may cost the family dearly.

Attorneys may wish to consider a savings clause/funding variant similar to the Clayton QTIP\(^{22}\) to save the use of the exclusion via bypass trust even if the Form 706 filing to claim portability is botched.\(^{23}\) The Clayton QTIP/bypass trust combination may also save additional basis if the surviving spouse dies within 15 months.\(^{24}\)

\(^{22}\) *Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir 1992) – decedent’s Will directed that if a QTIP election was not made for a trust that the assets moved to bypass trust with *different dispositive provisions*. See also Treas. Reg. §20.2056(b)-7(d)(3) “a qualifying income interest for life that is contingent upon the executor’s election under Section 2056(b)(7)(B)(v) [QTIP] will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse.”

\(^{23}\) **Example**: John wishes to leave his $5 million estate to his longtime wife Jane outright (ignoring all the reasons herein for ongoing trusts), but he certainly does not want to lose his exclusion amount, because his wife Jane also has a $5 million estate. His attorney therefore drafts a savings clause in his Will (or revocable trust) that leaves his available exclusion amount to a bypass trust, but if a proper estate tax return is timely filed to exploit the DSUEA (and the will/trust provisions may even require this, though this might give up some post-mortem flexibility), the assets instead go outright to his wife to the extent of the election. Thus, if the executor files the Form 706 timely and successfully “ports” $5 million DSUE, then $5 million goes outright. If the executor fails to timely file the Form 706 (or opts out), then $5 million goes into a liberal bypass trust for Jane. Either way, the exclusion is
Example: John dies leaving $1.25 million IRA outright and $4 million in non-IRA assets to his wife Jane in trust. To the extent a QTIP election is not made, the $4 million will go into a flexible bypass trust. If the QTIP election is made, the $4 million will go into a QTIP trust for Jane. Jane dies a year later with $5 million of her own assets (including the rollover IRA), and John’s trust has since appreciated to $5 million. John’s estate makes the QTIP election and elects to port all $5.25 million DSEU, Jane’s estate includes her $5 million plus the $5 million QTIP, and the entire estate receives a new basis (absent IRD/IRA assets etc). Conversely, John’s executor would not make the QTIP election had the market dipped and John’s trust depreciated to $3 million, to save the estate from a “step down” in basis.

Clayton QTIP arrangements have the added benefit over disclaimer funded trusts of permitting limited powers of appointment, as well as the six months of additional window of opportunity. Moreover, they do not have dicey acceptance and control issues as with qualified disclaimer rules, nor the same potential for fraudulent transfer, Medicaid or tax lien issues affecting disclaimants. Parties often assume joint brokerage accounts, for instance, can easily be disclaimed but tracing who contributed the funds may be crucial to disclaiming such accounts. However, Clayton QTIP arrangements are best made with an independent executor, whereas the identity of the executor with disclaimers is completely irrelevant.

Extreme, but not uncommon, scenarios such as this could save hundreds of thousands of dollars in basis by building flexibility into the plan. Even a heavy bond portfolio (approximately 10 yr duration) could easily decrease in value 25% if interest rates went up a

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24 As discussed in the next Part II, page 15, QTIPS elections can be made on a late return, but since DSUEA requires a timely filed Form 706, it is recommended that timely Forms 706 be filed for any substantial estates.


26 Treas. Reg. §25.2518-2(e)(4)(iii), even though IRC §2040(b) would deem 50% to be in each spouse’s estate

27 If spouse in role as trustee/executor causes his/her mandatory income to be removed, there is an argument that this causes a taxable gift (see the Regester case discussed later herein). If the surviving spouse is deemed a transferor of the bypass or QTIP trust, could this impair asset protection as self-settled trust and estate inclusion?
Practitioners should file for a six month extension on Form 706 even if no estate tax would be due to buy additional time for basis adjustment, even if one of the preferred Optimal Basis Increase Trust design options, discussed in Part III, is utilized.

b. Variations in Marital Trusts – Differences between GPOA, Estate and QTIP Trusts

Aside from the potential state estate tax deferral/savings, marital trusts receive a second step up in basis without sacrificing most of the protection and control of a trust. Succeeding trusts/beneficiaries generally receive a new basis when assets are in the surviving spouse’s estate, which marital trusts are. Varieties include the estate trust, general power of appointment marital trust and qualified terminal interest property (QTIP) marital trust.

An estate trust is very rarely used – it requires the spouse to be the only beneficiary and that the trust pay to the surviving spouse’s estate (but unlike other varieties, permits the trustee to accumulate income and retain property unproductive of income).

A GPOA marital trust is only slightly more protective of a settlor’s intent at the second death – it must grant the spouse the power to appoint to his/her estate without any other consenting party (a power to appoint to creditors is not enough).

The QTIP marital trust can be much more restrictive at second death than an estate or GPOA marital trust, by restricting or even omitting the surviving spouse’s power to appoint. Because of this and other advantages, QTIPs are by far the most preferred. However, especially in smaller estates of older couples with children of the same marriage, and in states with no state estate tax, the estate and GPOA marital trusts may see a rise in popularity because couples with smaller estates don’t need to file a Form 706 to get a second step up in basis and won’t get hit with additional valuation discounts hampering basis increase (discussed in next section).

28 [http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P204318 - 2% or more jumps happened several times within rather short time frames in the late 70s, early 80s.]
29 IRC §1014(b)(6),(9), (10).
30 See Rev. Rul. 68-554; Treas. Reg. §20.2056(c)-2(b)(1), but see unique applications for step up in basis planning discussed in Part V.
31 IRC §2056(b)(5), Treas. Reg. §20.2056(b)(3)(g)
32 At IRC §2056(b)(7) and IRC §2056(b)(5) respectively
33 If the GPOA does not bother a client for non-tax reasons, most of the other advantages, like reverse QTIP and optimizing GST, flexible use of previously taxed property credit if deaths are close together in time or valuation discounts, really only apply to larger taxable estates – irrelevant to more than 99% of the population now.
Example: John and Jane, married, in their mid-70s, have less than $1 million each. They wish to leave assets in trust to each other for all the various non-tax reasons herein, but want to preserve the second step up in basis at the second death. Using a QTIP design requires the first decedent’s executor to file a costly Form 706 with the appropriate QTIP election - otherwise, it’s no different than a bypass trust, and won’t get a step up in basis at the second spouse’s death. However, using a GPOA marital trust does not require such a filing. Even if no Form 706 is filed at the first death, assets in the GPOA marital get a new adjusted basis at the second death.34

GPOA trusts may also be preferred for taxpayers in states such as New York and New Jersey that do not permit a separate state QTIP election.35

c. The weak threat (and nifty loopholes) of Rev. Proc. 2001-38 for QTIPs

Another reason marital GPOA trusts might be preferred for taxpayers with estates under the applicable exclusion amount is the potential threat posed by IRS Rev. Proc. 2001-38. Rev. Proc. 2001-38 outlines a procedure whereupon, pursuant to taxpayer petition, a QTIP election may be disregarded, even though the election is irrevocable, under certain circumstances. It was clearly designed to help taxpayers who over-qtipped what should have remained a bypass trust where it was unnecessary to reduce estate tax. There is no indication yet that the IRS will use it as a weapon of attack, against a taxpayer’s interests, yet it does purportedly allow them to “disregard the [QTIP] election and treat it as null and void for purposes of sections 2044(a), 2056(b)(7), 2519(a) and 2652.”36 Since the basis rules under IRC §1014(b)(10) reference inclusion via IRC §2044, this would be a problem in preserving a second basis increase, because denying the QTIP election would deny inclusion under IRC §2044, and hence deny the new basis.

It is my position that this unilateral revenue procedure should not entitle the IRS to retroactively disregard a validly made QTIP election, a right granted by statute, on its own accord. Revenue procedures cannot overrule statutes and treasury regulations!

34 Under IRC § §1014(b)(9), not IRC §1014(b)(10)
35 See, The General Power of Appointment Trust is Back, Bruce Steiner, LISI Estate Planning Newsletter #2060 (February 6, 2013).
36 IRS Rev. Proc. 2001-38, see also PLRs 2009-18014, 2007-29028, 2010-36013, voiding valid QTIP elections
However, until the IRS issues further guidance, some practitioners may prefer to avoid the issue altogether and use a marital GPOA (or use inter vivos QTIPs, to which the Rev. Proc. does not apply if your state has fixed other inter vivos QTIP problems, or make a partial election (even 99%, which would also take the trust out of the Rev. Proc.’s apparent purview). This will depend on whether a GST/reverse QTIP election would be used, the compatibility of the estate plan with powers of appointment and other factors. QTIPs will probably remain the preferred vehicle for potentially estate taxable estates. Ultimately, the IRS will probably modify Rev. Proc. 2001-38 not only to clarify this point, but to prevent other obvious abuses of the procedure.

Aside from potentially using the Rev. Proc. to defer/avoid state estate tax, the Rev. Proc. also opens up an income tax/basis play probably not intended by the IRS. If the surviving spouse dies after a “market correction”, be it the bond market, stock market, real estate market, or other, the goal in planning is likely to avoid step downs in basis, not gain steps up. For example, let’s say a surviving spouse dies with a QTIP holding assets worth $3 million, with basis $4 million. The QTIP election wasn’t needed and, with 20/20 hindsight, isn’t desired. It was made purely on assumption that FMV would exceed basis by the second death. Can the surviving spouse’s executor simply “undo” the QTIP election made in the first spouse’s estate pursuant to Rev. Proc. 2001-38, to restore the original $4 million basis and prevent the step down to $3 million? This assumes this Rev. Proc. is not amended, as it probably should be.

d. The Estate/Basis/Valuation Advantage (for <1%), and Pitfall (for >99%) of QTIPs

GPOA trusts may also be preferred for taxpayers in the 99% who would fund a portion of real estate or fractional interests in LLCs/LP/S Corps, e.g., into trust.

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37 The problem with inter vivos QTIPs is that, after the death of the donee spouse, if assets come back to the donor spouse in trust, even though IRC §2044(c), Treas. Reg. §25.2523(f)-1(f), Example 11 would deem the donee spouse the grantor/transferor for 2036/2038 purposes, under most state laws, the donor spouse is still the settlor, making the trust self-settled and therefore subject to the donor’s creditors despite any discretionary standard or spendthrift provision, and therefore in the donor spouse’s estate indirectly under IRC §2041. See also Rev. Rul. 76-103. States that have recently fixed this issue are Arizona (Ariz. Rev. Stat. 14-10505(E)), Michigan (MCL §700.7506(4)), Virginia (Va.Code 55-545.05(B)), Ohio (Ohio R.C. §5805.06(B)(3)(b)), Delaware (12 Del Code 3536(c)(2), Florida (Fla Stat. 736.0505(3)), Texas (Cod. Tex §112.035(g)), South Carolina

38 The Treasury-IRS Priority Guidance Plan for the 12-month period beginning July 1, 2013, included a new guidance project described as “Revenue Procedure under §2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability.” As of August 2014, however, there is no such guidance issued.
Example: John and Jane, in the example above, plan to fund their trust with their 50% interest in a home, total value $600,000 and 50% of rental property LLC, underlying asset value $500,000. If a QTIP is used, the surviving spouse’s estate must value the ½ in the QTIP and the ½ in the surviving spouse’s estate separately, generating a fractional interest, and/or marketability, non-controlling interest “discount”. At second death, these “fair market values” might total $500,000 and $300,000 respectively, rather than $600,000 and $500,000 (a 50% LLC interest would probably have a greater discount than a 50% tenancy in common interest). This effect would be exacerbated further if John and Jane owned less than 100% of the LLC, since a 49% or less interest would be typically be discounted more than 50%.

This reduction in valuation would be optimal planning if Jane had a taxable estate, but for most people, “discounting” will save no estate tax and cost the heirs significant basis increase – for Jane and John’s family, $300,000. Had the 50% interest in the home and 50% LLC interest gone to a GPOA marital trust for the survivor, or through any other trust with a testamentary general power, as discussed in Part III, the two halves would be valued together for estate tax at the second death, and therefore retain full “undiscounted” basis.39

e. How to Adapt QTIPs for Better “Step Up”

There are several solutions for the fractional interest discount issue, although many practitioners will find them odd and counterintuitive – first, use a formula general power of appointment (discussed in Part III) designed to pull such assets into the estate under IRC § 2041 as well as IRC §2044 to accomplish consolidation for valuation purposes. Such a power would be designed so as not to qualify the trust under IRC §2056(b)(5), yet be permitted to be retained under IRC §2056(b)(7). The public policy behind the consolidation for valuation purposes is that the surviving spouse, via GPOA, effectively controls 100% of the combined assets (whereas a QTIP often offers little if any control). There is nothing in §2056(b)(7) that precludes adding this feature, and since the assets are included in the estate anyway, there is

little to be lost even under a worst case scenario. The difficulty would lie in crafting the power
to be capped or negated in the unlikely scenario that the increase in valuation due to
aggregation would cause a federal or state estate tax. **For example:** Jane has a $2 million in
assets of her own, $3 million in her late husband’s QTIP trust. Part of Jane’s assets is a 50%
interest in an LLC that owns $2 million in property. Part of the QTIP’s assets is the other 50%.
These 50% LLC interests are valued at $700,000 separately for each interest (discounted 30%
from $1 million each). This discounting would be great planning if Jane had a taxable estate,
but with DSUE she has $10.86 million AEA. A GPOA would aggregate the valuation at Jane’s
death so as to increase the gross estate from $5 million to $5.6 million (100% of LLC should
normally have little if any discount), adding $600,000 of basis. See various examples in
appendix and discussion of capping GPOAs to prevent estate tax in Part III.

Would QTIP inclusion via IRC §2041(a)(3) (using a limited testamentary power of
appointment to trigger the Delaware tax trap) lead to the same aggregation? While it is
triggering the same statute causing estate inclusion (§2041), the same public policy argument
discussed in *Fontana* and the IRS memos justifying the valuation aggregation for GPOAs is not
quite the same. In short, there is a compelling argument that assets appointed under a
“Delaware tax trapping” LPOA (discussed in Part III) should be aggregated with a QTIP spouse
and power holder’s other assets for estate tax valuation, but it is not quite as certain as with
“standard GPOA” assets, since there is no case law on point yet.

Adding a formula testamentary general power would also add another nine month
window for subsequent beneficiaries to disclaim after the second death, as discussed in Part II
and IV.

Second, the LLC (or Tenancy in Common) agreement can be drafted or amended to
essentially remove the discounts provided all the parties agree. In the LLC context, I call this
the Optimal Basis Increase LLC.\(^{40}\) In some cases this would be necessary to optimize basis in
addition to a general power of appointment (e.g. if the surviving spouse and spouse’s trust
together did not own 100%). This would basically entail adding some of the provisions that

\(^{40}\) See separate presentation and material by author.
Thus, marital trust planning can combine most of the income tax basis benefit of the outright/portability option with the estate preservation and most of the asset protection planning advantages of a bypass trust. Marital trusts can at least partially solve the first major drawback of the bypass trust discussed above — basis at the second death, and can solve most of the baker’s dozen drawbacks of outright planning discussed in Part I above.

But we might do even better. After all, marital trusts typically don’t solve the higher ongoing income tax issue, which is probably of greater concern to surviving spouses, and are problematic in that they also receive a second step down in basis. Moreover, they cannot spray income as a bypass trust could and they are leaky for both asset protection and tax reasons, because of the mandatory income requirement. They cannot be structured as third party created wholly discretionary trusts not counted as a resource or income for Medicaid or other benefit purposes. They cannot have protective forfeiture provisions like a bypass trust might. They provide greater complications for see-through trust status (aka “stretch IRAs”), especially for GPOA marital trusts, and may force out IRA distributions where none would otherwise be required. They cannot use broad lifetime limited powers of appointment — which can be important for gifting and income tax planning techniques discussed in Part VIII. They cannot be used by non-traditional couples who are not officially recognized as “married.” QTIPs have more onerous and complicated tax apportionment. QTIPs have more problematic issues with estate freeze, entity planning and gifting/termination due to

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41 Although the general rule is that RMDs are required post-mortem, there is a limited exception and permitted delay for spousal conduit trusts (where the spouse is considered the sole “designated beneficiary”), where the decedent died before his/her required beginning date. IRC §401(a)(9)(B)(iv) “Special rule for surviving spouse of employee.” If the designated beneficiary referred to in clause (iii)(I) is the surviving spouse of the employee—(I) the date on which the distributions are required to begin under clause (iii)(III) shall not be earlier than the date on which the employee would have attained age 70 1/2”. If QTIP is elected, a typical trust will require that the minimum of net income from the IRA and the trust separately must be paid — even when there is NO RMD.

42 IRC §2056(b)(7)(B)(ii)

43 After the Supreme Court struck down Section 3 of the Defense of Marriage Act (DOMA) recently in Windsor and the IRS issued Rev. Rul. 2013-17, same sex couples in a legally recognized marriage will now get the marital deduction. However, this does not include registered domestic partners or similar statuses.

44 IRC §2207A. States also have their own variants that affect QTIPs, such as Ohio R.C. §2113.86(I)
§2519. DSUE gained through overuse of marital trusts can be lost via botched filing, or remarriage combined with split gifts or a subsequently deceased 2nd spouse. Marital trusts have much more limited adaptability under most trust protector/amendment clauses and state decanting statutes. They risk greater “discounts” and lower basis when the spouse and QTIP own fractional interests in the same property. Some attorneys believe (though not this author) that the IRS may even deny the QTIP election and step up in basis at the surviving spouse’s death pursuant to Rev. Proc. 2001-38. Overuse of portability may cause the surviving spouse’s estate to go above the gross filing threshold (generally, $5.45 million adjusted for inflation), forcing the spouse’s estate to file Forms 706 and the nasty new Form 8971 with the “zero basis” problem whereas bypass trust usage may have avoided that.\(^45\)

Furthermore, marital trusts simply won’t be as efficient in saving state estate taxes or federal estate taxes for estates close to the state or federal applicable exclusion amount, especially if the surviving spouse lives long and assets appreciate significantly, since the DSUE amount is not indexed for inflation.

g. **What ways other than using marital deduction trusts could we achieve a second step up in basis at the surviving spouse’s death on assets in a bypass trust?**

We could build greater flexibility to accomplish the same goals by either:

1) giving an independent trustee (or co-trustee, or “distribution trustee”) discretion to distribute up to the entire amount in the bypass trust to the surviving spouse;

2) giving an independent trustee or trust protector the power to add general testamentary powers of appointment, or effecting the same via decanting or other reformation under state law if enough trustee discretion is granted;

3) giving another party (typically a child, but it could be a friend of spouse or non-beneficiary), a non-fiduciary limited lifetime power to appoint to the surviving spouse;\(^46\)

4) if the trust otherwise qualifies, and no return was ever filed to **not** make a QTIP election, try to file a late Form 706 and make a late QTIP election.

5) giving the surviving spouse a limited power to appoint, but enabling the appointment to trigger the Delaware Tax Trap over the appointed assets;\(^47\)

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\(^{45}\) IRC §6018 (filing threshold), §6035 (Form 8971) and Treas. Prop. Reg. § 1.1014-10(c)(3)(i)(B) “zero basis”

\(^{46}\) This is known as a collateral power, See *Restatement Property, Third, Donative Transfers*, §17.3, comment f
6) giving the surviving spouse a limited power to appoint that alternatively cascades to a general power to the extent not exercised. 48

7) giving the surviving spouse a general power to appoint appreciated non-IRD assets up to the surviving spouse’s remaining applicable exclusion amount.

This article will focus on the advantages of the last three of these, referred to as an Optimal Basis Increase Trust. The problem with the first two above techniques, which involve placing the burden on the trustee or trust protector, is that they are often impractical and require an extraordinary amount of proactivity and omniscience, not to mention potential liability for the trustee/trust protector. Gallingly, clients don’t tell us when they are going to die, hand us accurate cost basis and valuation statements, marshal beneficiary agreement and give us enough time to amend, decant or go to court to change the estate plan to maximize tax savings. Furthermore, fiduciaries taking such drastic steps are likely to wish to hire counsel, get signed waivers, or consult a distribution committee — time for which may be scarce in a situation where the surviving spouse is hospitalized or terminally ill.

Distributing assets outright to the surviving spouse, even if clearly under the authority of the trustee, protector or donee of a power of appointment, risks losing the asset protection for the family and risks a disinheritzance or removal outside in the family bloodline. If the distribution is arguably beyond the trustee’s authority (e.g., the distribution standards are only for “health, education and support”), even with children’s consent, the IRS may see it as collusion to avoid tax, that funds were held in constructive trust by the decedent, therefore must be denied inclusion/step up. 49 Or, if the children are deemed to have made a gift, then

47 IRC §2041(a)(3), IRC §2514(d). While it’s very simple to add a LPOA that would in theory permit this, understanding the DTT involves considerable complexity. Michigan and Ohio have recently amended their Rule Against Perpetuities to specifically prevent most unintentional triggerings of the “trap”, but clearly permit intentional triggerings by appointing to a trust that has a presently exercisable general power of appointment and therefore triggering IRC §2041(a)(3). See Ohio R.C. §2131.09, and a comprehensive article on the subject from Attorney James Spica regarding Michigan’s RAP at http://www.michbar.org/probate/pdfs/Summer08.pdf

48 A rather clever variation that the IRS fought, lost and finally acquiesced to in Chisholm v. Commissioner, 26 T.C. 253 (1956), but beware Restatement of Property, Second, Donative Transfers §13.1(c), which would deem any LPOA to be a GPOA if the gift in default of exercise were to pass to the powerholder’s estate.

49 E.g. in McCombs v. United States, 248 F. Supp. 568 (W.D. Ky 1965), widow/children tried to argue that widow had a GPOA to qualify for marital estate tax deduction, and even went to state court and distributed the entire trust to the widow outright. Despite the state court decree, the fed court denied the marital deduction, because the trust did not authorize her to receive outright or GPOA equivalent rights – could the IRS use a similar argument re income tax? I think so, unless state law to terminate the trust is closely followed. See also Stansbury v. U.S., 543 F. Supp. 154 (N.D. Ill. 1982) – funds held in constructive trust for another held not to be in a decedent’s estate.
their exclusion would be used (perhaps not a big deal) and §1014(e) deny the step up in basis (see comparison chart in the appendix comparing various options). Plus, we’ve all heard cases of someone on death’s door that miraculously makes a full recovery and lives another decade or more. Once the assets are out of trust, you can’t simply put them back in and be assured the same tax results.

Adding a general testamentary power of appointment does not have the same level of risk, nor the same destruction of asset protection from outside creditors, as an outright distribution.\(^{50}\) Some trusts will have a trust protector provision that allows this, and several states have a decanting statute that allows GPOAs to be added if there is enough discretion granted the trustee.\(^ {51}\) However, it merely begs the question – if it’s worth doing later, why isn’t it worth doing now before it’s too late?

Granting the ability for a trust protector to add GPOA basis savings clauses later without actually adding it is like GM or Toyota deciding to leave a space for air bags and seat belts and telling people they can always go back to a mechanic to add them later. Would an attorney a decade ago have told wealthy married clients to just “skip the AB trust provision, we’ll include a trust protector provision to add it in later?” Why not add the safety net now and allow it to be amended if it can later be improved?

h. Are Trust Protector Powers to Add General Powers of Appointment Dangerous?

Distinguished attorneys have cautioned against giving non-adverse parties such as trust protectors, trustees or trust advisors the ability to add GPOAs (beyond what state law already grants in the trust code, decanting statute, etc.)\(^ {52}\) The worry is that this may be deemed to create a current general power of appointment over the entire trust in itself. Consider this theorem: if spouse has a GPOA only exercisable with consent of a trust protector (assume the TP is not a child or remainderman, which is highly likely), we know this is still a taxable GPOA because the consenting party is non-adverse.\(^ {53}\) Is this so different from a non-

\(^{50}\) See Restatement of Property, Second, Donative Transfers, §13.2 Creditors of the Donee - Unexercised General Power Not Created by Donee. If creditor protection is a potential threat, and state law is unfavorable, consider the LPOA/DTT variant (assuming of course, state law easily allows triggering the trap).


\(^{52}\) Identifying and Respecting the Core Elements of a Modern Trust, comments by Ronald Aucutt, 48th Annual Heckerling Institute on Estate Planning ¶1305.1[B]

\(^{53}\) IRC §2041(b)(1)(C)(ii)
adverse party (trust protector) being able to grant a spouse a GPOA? Both variations allow a GPOA to be exercised only with the consent of the spouse and trust protector who is non-adverse. Could this be merely a semantic difference as some warn?

I would argue this is not substantially different from an independent, non-adverse trustee with the sole discretion to pay the entire amount of a trust to a spouse or other beneficiary, or a non-beneficiary holding a lifetime limited power of appointment enabling the same. No one argues that these longstanding powers cause a GPOA and estate inclusion, yet they are substantially the same. We don’t consider the spouse and non-adverse trustee’s powers together because the trustee has a fiduciary duty to all beneficiaries, including remaindermen. When we look at it this way, we probably see some absurdity and conclude such trust protector powers cannot create a GPOA in people by the mere power to add a GPOA later – else the IRS would have long since hammered thousands of trusts with estate inclusion. However, it may matter if the trust protector or other advisor is not considered a fiduciary and held to no fiduciary duties in his or her ability to add a GPOA. Some attorneys will draft, and some state laws will allow, trust protectors/advisors to be considered non-fiduciaries. If so drafted, such clauses may be riskier, because they are more truly analogous to a spouse and non-adverse party jointly controlling a general power of appointment.

To summarize, while it is not a strong argument, why tempt it? If you allow a trust protector or other party to grant or amend a beneficiary’s GPOA, especially if the party is not considered a fiduciary, consider capping and limiting the scope of the GPOA the trust protector/advisor may add (as discussed in the following Part III and in Appendix).

The third technique, using a limited lifetime power of appointment (aka collateral power), simply moves the burden to someone other than the trustee, and may lead to many difficult issues even in traditional families. A lifetime limited power to appoint could be made conditional upon unanimous consent of the children, but this of course brings up the possibility of one child’s obstinance holding back the family’s tax planning.

The 4th technique above, making a late QTIP election, may surprise people. Some bypass trusts might qualify as a QTIP with the proper election (e.g. if spouse is sole beneficiary during his or her lifetime and entitled to demand/receive all net income). A QTIP election can
be made on the last timely filed estate tax return, or, if no timely return is filed, on the first late return.\textsuperscript{54} This might be a full or, perhaps better for Rev. Proc. 2001-38 reasons, partial election. You need not reopen a probate estate to appoint an executor, the trustee may file.\textsuperscript{55} If estate administration is finished, it may be too late to divide a trust subject to partial election into two separate trusts for optimal efficiency.\textsuperscript{56} Conceivably, the trustee could even wait until after the death of the surviving spouse so that the QTIP election “relates back” to cause inclusion in the surviving spouse’s estate to seize the additional step up in basis. This could cause serious headaches with a Clayton QTIP arrangement. More importantly, however, planning for a late QTIP election is simply not a viable proactive planning technique because failing to timely file a Form 706 eliminates, or at best jeopardizes, portability.

So, how do we better ensure that assets get the maximum step up possible, not a step down, don’t cause extra state estate tax (or federal), and achieve better ongoing income tax treatment and asset protection than a typical bypass or marital trust, without the above drawbacks?

Let’s turn to the final three methods above, which use formula powers of appointment to allow for firmer and more precise tax planning. I will refer to all of these variants together as an \textit{Optimal Basis Increase Trust} (OBIT).

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{54}] Treas. Reg. §20.2056(b)-7(b)(4)(i). Be careful using this for state estate tax planning, some states (formerly, this was the case in Ohio) may not follow federal law to allow a late filing for a state-equivalent QTIP.
\item[\textsuperscript{55}] Treas. Reg. §20.2056(b)-7(b)(3)
\item[\textsuperscript{56}] Treas. Reg. §20.2056(b)-7(b)(2)
\end{itemize}
\end{footnotesize}
Part III - The Optimal Basis Increase Trust (OBIT)

"Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands."
- Judge Learned Hand, Gregory v. Helvering, 69 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935)

a. Introducing the Targeted Formula GPOA Concept

Using testamentary general and limited powers of appointment more creatively can assure that assets in the trust receive a step up in basis, but not a step down in basis, and these powers can be dynamically defined or invoked so as to not cause additional estate tax.

Example: John Doe dies in 2013 with $2 Million in assets left in trust for his wife Jane. She files a Form 706 and “ports” $3.25 million DSUE. We’ll assume that most of this gain has been realized, though with more tax efficient or buy/hold strategy, realization would be much less. After 8 years, when she dies, these trust assets have grown to $4 million, as follows:

<table>
<thead>
<tr>
<th>Property</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional deductible IRA&lt;sup&gt;57&lt;/sup&gt;</td>
<td>0</td>
<td>$700,000</td>
</tr>
<tr>
<td>Total “IRD” Property</td>
<td>0</td>
<td>$700,000</td>
</tr>
<tr>
<td>Apple Stock (the iPhone 9 flopped),</td>
<td>500,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Condo in Florida (hurricane depresses value),</td>
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<td>$600,000</td>
</tr>
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<td>LT Bond portfolio (inflation depressed value)</td>
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<td>$300,000</td>
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<tr>
<td>Various stocks that have decreased in value</td>
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<td>$100,000</td>
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<tr>
<td>Total “loss” property</td>
<td>2,050,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Rental Real Estate&lt;sup&gt;58&lt;/sup&gt;</td>
<td>200,000</td>
<td>$600,000</td>
</tr>
</tbody>
</table>

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<sup>57</sup> In many cases, I would not recommend that an IRA be used to fund a bypass trust, since a spousal rollover has better income tax treatment, but it may be preferable when needed to soak up estate tax exemption, or for various non-tax reasons. This is mostly included to show the lack of effect on basis on IRD at death. If an accumulation trust (as opposed to conduit trust) design is used, consider a separate or standalone trust so that no broad power to appoint can be construed to apply to the retirement benefits. Blanket savings clauses may not save the stretch, especially since most POAs by default can include non-qualifying trusts as appointees. See Restatement of Property, Third, Donative Transfers §19.14, other IRA CLE and checklist materials developed by author and ¶6.3.09, Life and Death Planning for Retirement Benefits, 6th Edition, by Natalie Choate.

<sup>58</sup> If real estate is held in an LLC/LP or other entity taxed as a partnership, the underlying assets do not automatically get a date of death basis even if the LLC/LP is in the decedent’s estate, but the partnership may make an election under IRC §754 to step up inside basis. Treas. Reg. §1.754-1. Advisors to the 99% should consider REDUCING discounts to FLPs/LLCs by amending operating agreements (adding put/termination rights, etc), despite articles stating essentially “you can just reduce the discount you take”, which is absolute nonsense.
Various stocks that have increased in value
ST Bond Portfolio, Money market, Cash
Gold
Total “gain” property
Total at Jane’s death

basis $400,000, FMV $900,000
basis $400,000, FMV $400,000
basis $100,000, FMV $200,000
basis $1,100,000, FMV $2,100,000
basis $3,150,000, FMV $4,000,000

Had John used an outright bequest, or a marital trust, all of the assets above (except the IRA) would get a new cost basis – including the loss properties. Had John used an ordinary bypass trust, none of the assets above would get a new cost basis, including $1 million of unrealized gains (see chart below)!

Instead, John’s Optimal Basis Increase Trust (OBIT) grants Jane a limited power of appointment (or no power at all) over all IRD assets and assets with a basis higher than the fair market value at the time of her death (total assets $1.9 million). It grants Jane a general power of appointment (“GPOA”) over any assets that have a fair market value greater than tax basis (total assets $2.1 million). As discussed below, this may also be accomplished with a limited power of appointment (“LPOA”) that triggers the Delaware Tax Trap.

59 Potentially, the QTIP may be worse than an outright marital transfer if there is no estate tax, since you may have discounting if, for instance, a QTIP owns half the home and the surviving spouse owns half – this would result in less basis for remaindermen than if the surviving spouse had owned the whole.
### Step up caused by formula
GPOA or LPOA and §2041(a)(3)

### Comparing the Effect of OBIT v. QTIP v. Bypass

**New Basis at Surviving Spouse’s Death if using:**

<table>
<thead>
<tr>
<th></th>
<th>Ordinary Bypass</th>
<th>QTIP/outright</th>
<th>OBIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional deductible IRA</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Apple Stock (the iPhone 9 flopped),</td>
<td>$500,000</td>
<td>$200,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Condo in Florida (hurricane depresses value),</td>
<td>$1,000,000</td>
<td>$600,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>LT Bond portfolio (inflation depressed value)</td>
<td>$400,000</td>
<td>$300,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Various stocks that have decreased in value</td>
<td>$150,000</td>
<td>$100,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Rental Real Estate</td>
<td>$200,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>Various stocks that have increased in value</td>
<td>$400,000</td>
<td>$900,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>ST Bond Portfolio, Money market</td>
<td>$400,000</td>
<td>$400,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Gold</td>
<td>$100,000</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td><strong>Total Basis for Beneficiaries at Jane’s death</strong></td>
<td><strong>$3,150,000</strong></td>
<td><strong>$3,300,000</strong></td>
<td><strong>$4,150,000</strong></td>
</tr>
</tbody>
</table>
**Result:** John and Jane Doe’s beneficiaries get a step up on the trust assets, but, more uniquely, do not get a “step down” in basis for any loss property (in our example, new basis is $4,150,000 versus $3,150,000 had a standard bypass trust been used and only $3,300,000 of basis had a marital trust been used. *That’s a lot of savings.* The beneficiaries (through a continuing trust or outright) get a carry over basis over any assets received via limited power of appointment (or received by default if such assets were not subject to a general power of appointment at death). This allows them to use the higher basis for depreciable assets to offset income, or sell assets to take the capital loss to offset other capital gains plus $3,000/yr against ordinary income, or hold for future tax-free appreciation up to basis.

Think people won’t die with unrealized capital losses? It happens all the time. Ask anyone who handled an estate in 2008-2009. It is a dangerous misnomer to call the basis adjustment at death a “step up” without realizing it’s equally a “step down” when assets don’t appreciate as we had wished them to; yet we are all guilty of this pollyannaish shorthand. Increasing trust capital gains tax rates, discussed in more detail in Part II and VIII, may cause more tax sensitivity, meaning more use of individually managed bonds and equities or at least low-turnover funds or ETFs in order to decrease turnover and gains realization, which may mean even more unrealized gains in future irrevocable trusts.

*Why haven’t people done this before?* Besides the frustrating instability of the transfer tax regime and the smaller exemptions prior to EGTRRA, there are two main reasons: if not properly curtailed with careful drafting, it could increase estate tax exposure and decrease testamentary control by the first spouse to die. Solutions for these two issues will be discussed below. Regarding the first reason, we need to wake up and smell the new paradigm. What percentage of the population cares about the estate tax now, even with some assets included in both estates?

Let’s revisit our example above. Let’s say Jane has $3 million of her own assets. Her DSUE from her late husband John was $3.25 million (frozen, not adjusted for inflation), and her own basic exclusion amount is $6.25 million ($5.25 million plus 8 years of estimated inflation adjustments adding $1 million more). Even if she had missed the Form
706/portability filing, adding $2.1 million to her estate doesn’t even come close to her $9.5 million applicable exclusion amount. But what if Jane wins the lottery and has $9 million in her estate without John’s trust? Could this type of trust provision cause $640,000 of additional estate tax ($9 million plus $2.1 million, minus $9.5 million AEA, times 40% rate)?

c. Capping the GPOA to Avoid State and/or Federal Estate Tax

Fortunately, John’s Optimal Basis Increase Trust includes a formula. The GPOA is only applicable to those assets to the extent it does not cause increased federal estate tax (and takes into account state estate tax, discussed further below). Powers of appointment can be limited in scope as to either appointees or assets. Many existing trusts already have GPOAs over only a portion of the trust (typically, the GST non-exempt share). There is no reason one cannot grant a general power of appointment over less than 100% of trust assets, or by formula. All of our traditional planning has A/B/C, GST formulas that the IRS has blessed and this should be no different. You can select assets specifically subject to the power (e.g. an asset that you know the next generation will sell), or carve out assets not subject to the power (e.g. an asset that you know the next generation will not sell).

Furthermore, the appointment could be applicable to the assets with the greatest embedded gain to satisfy this amount. The drafting difficulty is not so much in capping the GPOA but in creating the optimal ordering formula and adjusting for state estate taxes.

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60 Treas Reg. §20.2041-1(b)(3) states that “(3) Powers over a portion of property. If a power of appointment exists as to part of an entire group of assets or only over a limited interest in property, section 2041 applies only to such part or interest.” There are probably dozens of cases and rulings about limiting powers and funding trusts with “caps” - a few in the formula GPOA context are PLR 2001-23045, 2000-101021, 2002-10051, 2004-03094, 2006-04028 (discussed in Part V), PLRs 9110054 and 9527024 (discussed extensively later in this Part). If a decedent dies with an unexercised 5/5 power, it’s clear that 5% is included in estate, and 5% is stepped up accordingly. Prokopov v. Commissioner, 166 F3d 1201 (2nd Cir. 1998).

61 Formulas tied to tax exemption have always been used for AB/GST funding, and formula gifts designed for specific tax results have had recent success in the Wandy, Petter and Christiansen line of cases, but there are good examples even in Treasury guidance. See Treas. Reg. §25.2518-3(d), Example (20) in the area of qualified disclaimers: “A bequeathed his residuary estate to B. B disclaims a fractional share of the residuary estate. Any disclaimered property will pass to A’s surviving spouse, W. The numerator of the fraction disclaimed is the [smallest amount which will allow A’s estate to pass free of Federal estate tax and the denominator is the value of the residuary estate]. B’s disclaimer is a qualified disclaimer.” An OBIT formula is the same concept applied to powers of appointment. See other formulas blessed in Rev. Rul. 64-19 (A/B trusts), Treas. Reg. §26.2632-1(b)(4), (b)(2)(11) and (d)(1) (GST formula allocation); Treas. Reg. § 1.644-2(a)(1)(iii); Rev. Rul. 72-395, 1972-2 C.B. 340; Treas. Reg. § 20.2055-2(c)(2)(vi)(a)(split interest charitable trusts); Treas. Reg. § 25.2702-3(b)(1)(ii)(B)(Formula transfers to a GRAT), and other PLRs discussed herein.
d. Determining the Appointive Assets When the GPOA is Capped

Let’s take the non state-taxed situation first. In our lottery scenario above, Jane’s estate has only $500,000 of applicable exclusion to spare, but the appreciated “stepupable” assets of the OBIT total $2.1 million. Which assets should be stepped up first?

Assets that may incur higher tax rates, such as collectibles (artwork, antiques, or gold, in the example above) would be natural candidates for preference. On the opposite end of the spectrum, other assets might have lower tax rates or exclusions, such as qualifying small business stock or a residence that a beneficiary might move into, but those would be relatively rare situations. Most families would prefer the basis go to depreciable rental property, which can offset current income, before allocating to stocks, bonds, raw land, family vacation home, etc. Therefore, ultimately a weighting may be optimal, or even a formula based on tax impact, but at the most basic level practitioners would want the GPOA to apply to the most appreciated assets first.

Some of this analysis will sound similar to those who handled estates of those who died in 2010 when the price to pay for no estate tax was a limited step up in basis. While the concept sounds similar, in practice, it is quite different. In 2010 the executor could choose assets to apply a set quantity of basis to, pursuant to specific statute. Ideally, we would like to give Jane’s executor or the trustee the power to choose the assets to comprise the $500,000 of appointed assets – in both drafting and in practice that is deceptively simple. However, this is quite different from 2010 carry over/step up law, and different from “pick and choose” formula funding.

If the power of appointment is deemed to apply to a pecuniary amount (here, $500,000), rather than a fractional formula (500,000/2,100,000), it may have undesired income tax consequences upon funding.63

62 IRC §1022
63 See IRS Chief Counsel Memorandum (CCM) 2006-44020 regarding IRD assets. Also see Treas. Reg. §1.1014-4(a)(3): “Thus, for example, if the trustee of a trust created by will transfers to a beneficiary, in satisfaction of a specific bequest of $10,000, securities which had a fair market value of $9,000 on the date of the decedent’s death (the applicable valuation date) and $10,000 on the date of the transfer, the trust realizes a taxable gain of $1,000 and the basis of the securities in the hands of the beneficiary would be $10,000. As a further example, if the executor of an estate transfers to a trust property worth $200,000, which had a fair market value of $175,000 on
Thus, we should avoid simple powers of appointment over, for example, “the maximum amount of assets that would not cause my spouse’s estate to incur state or federal estate or generation skipping transfer tax” – even though this may not be a problem in many cases, and usually far superior to doing nothing.

If Jane’s testamentary power potentially extends to all of the applicable property equally ($2.1 million), only limited to $500,000, all property subject to that provision should get a fractional adjustment to basis accordingly – no different than if a child dies at age 36 and had a power to withdraw 1/3 of corpus at age 35 and did not take it – all assets would get a 1/3 basis adjustment.\(^\text{64}\) A pro rata adjustment would lead to wasted basis, since a $1,000,000 asset with $1 gain would soak up the same applicable exclusion amount as a $1,000,000 asset with $900,000 gain. This would be better than no extra basis at all, but not as optimal as the trustee limiting the powerholder’s general power, or, more conservatively, establishing an ordering rule to determine exactly which property the power pertains to.

**Trustee Choice v. Ordering Rule**

The trustee might be given a fiduciary limited power of appointment to choose the appointive assets subject to the beneficiary’s testamentary GPOA. Black letter law defines a power of appointment as “a power that enables the donee of the power to designate recipients of beneficial ownership interests in or powers of appointment over the appointive

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\(^\text{64}\) If the power to withdraw 1/3 had lapsed, 5% might be “lapse protected”, causing slightly less to be in the beneficiary’s estate (and thus less basis adjustment).
property.  Arguably, a trustee with such a power would be the donee of a fiduciary limited power of appointment to designate recipients of powers of appointment over the appointive property.

While this is fundamentally different in some ways from AB funding formulas that involve trustee choice, the IRS may try to apply a “fairly representative” requirement anyway. Moreover, because the power does not apply to specific assets at death, it may be seen as a fulfillment of a pecuniary amount, rather than a power over specific assets, with attendant post-mortem gain triggering issues discussed above. Arguably the power holder’s GENERAL power, once curtailed by the trustee’s fiduciary limited power, is only over specific assets chosen by the trustee. But I would not count on an IRS agent understanding this.

Moreover, what if the beneficiary does not exercise the GPOA? This would be quite common. Would the IRS try to ignore the trustee’s choice as moot except for the tax effect and attempt to disregard it, since the trustee’s “choice” has no effect on where the assets go or how they are administered? It’s not a strong argument. All in all, it is probably more conservative and simpler in concept to simply make clear the GPOA never applies to the less appreciated assets, and is never subject to any trustee’s discretionary choice.

So, in our example, the trust provides that the GPOA applies to the most appreciated asset first, cascading to each next individual asset until $500,000 in total property is reached. In our case, the real estate has the greatest appreciation (assuming there is not a more appreciated stock in “various stocks” category), thus the GPOA would apply to 5/6 interest (be it % as tenant in common, or more likely, % LLC membership interest). Thus, the basis would be increased to FMV on the date of Jane’s death as to 5/6 of the property (5/6 times $600,000, or $500,000) and the remaining 1/6 would retain its carry over basis (1/6 of

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65 Restatement, Third, Property, Wills and Other Donative Transfers §17.1, see also Uniform Powers of Appointment Act, §102(13)
66 See comment g in Restatement, Third, Property, Wills and Other Donative Transfers §17.1
67 Rev. Proc. 64-19, which has to do with post-mortem gains/losses when distributing in kind based on DOD value
68 Perhaps a solution to this aspect would be to have a different takers in default provision for assets subject to a GPOA lapse than for assets subject to an LPOA lapse, making the trustee’s choice have real effect on property rights. An example would be to instruct the trustee of the subtrusts to exhaust funds funded via GPOA lapse first, similar to traditional clauses in bypass/QTIP and GST exempt/non-exempt bifurcated trusts that encourage spending from non-exempt/QTIP assets prior to GST exempt.
$200,000, or $33,333). This means a basis increase from $200,000 to $533,333. This method could easily make for a rather extensive spreadsheet when dealing with dozens if not hundreds of individual stock positions, but it’s less burdensome than what 2010 executors had to deal with for carryover basis, and is not much of an issue with modern spreadsheets.

In our ordering example, the GPOA could never apply to the less-appreciated assets, and hence the IRS would have no statutory basis to include them in Jane’s estate (or accord them an adjusted basis). It applies to specific property, not a dollar amount or a fraction (though it could apply to say, 34 of 100 shares, etc). If the most appreciated property is family business stock, that’s what it applies to, and there is no discretion in the trustee or the powerholder to change the appointive assets subject to the GPOA. While this gives up some flexibility over the trustee power noted above, it is probably the more conservative route.

**Income Tax Certainty by Forcing a Form 706 Filing for the Power Holder’s Estate**

Some argue that a formula GPOA, if the appointive assets are large enough to trigger a cap, triggers a Form 706 filing and additional estate expense. This is true, because even with a zero-tax formula, the gross estate before will always be larger than applicable exclusion. The requirement to file an estate tax return is based on the gross estate, not the net. This is actually a significant tax benefit. The reason is that, when a Form 706 is required to be filed, the IRS is locked into the basis of hard to value assets for subsequent income tax purposes:

(a) Fair market value. For purposes of this section and § 1.1014-1, the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its fair market value. If no estate tax return is required to be filed under section 6018 (or under section 821 or 864 of the Internal Revenue Code of 1939), the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable.

This helps to ensure certainty for later depreciation and capital gains calculations, not only for the appointed assets, but the power holder’s other estate assets as well.

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69 The example did not specify whether the property TIC or LLC shares in trust was 100% or a mere fractional share. I assume here that taking 5/6 of the property is valued at 5/6 of the whole, which might be the case if the trust owned e.g. 40%. If the trust owned 100% or 51% of the LLC, it may apply to a greater number of shares/membership interests.

70 IRC § 6018(a)

71 Treas. Reg. § 1.1014-3
e. Issues if the Spouse is Sole Trustee or Investment Advisor

If the spouse is the sole trustee or sole investment advisor under direction or delegation, could his or her indirect power to manipulate gains and losses on investments, and therefore basis, somehow deem such powers to be general over all the assets up to the remaining applicable exclusion amount? This would be quite a stretch, since the Uniform Prudent Investor Act and other common law fiduciary duties preclude any self-dealing or avoidance of diversification unless the document waives them.72 There is a longstanding duty of impartiality imposed on trustees.73 Thankfully, there is a regulation to protect from this:

“The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.”74

Still, this may be one more reason for a conservative practitioner to use an independent trustee, co-trustee and/or investment trustee. There are important side benefits to this – better asset protection when a current beneficiary is not sole trustee, protecting the surviving spouse from breach of fiduciary duty charges from remaindermen for bad investment decisions, or protecting the family from such mismanagement in the first place.75

If such a design is still undesirable, consider granting the spouse a limited testamentary power of appointment eligible to trigger the Delaware Tax Trap, which could be over all assets equally. Any structuring to exploit a step up or avoid a step down would be done through the spouse’s own Will or Trust exercising the non-fiduciary LPOA over only specific assets, rather than through the trust document or vagaries of investment return, and

72 See, Gifts by Fiduciaries by Tax Options and Elections, November/December 2004 issue Probate and Property, by Jonathan Blattmachr, Stephanie Heilborn and Mitchell Gans, for a good discussion of gift tax effects of interested fiduciary decisions regarding Clayton QTIPs, investment choices, alternate valuation date, choice of where to deduct expenses and other dilemmas, concluding that independent fiduciaries are generally safer, but that investment choices by a beneficiary/trustee should not lead to GPOA inclusion.

73 Restatement, 3d, Trusts, §79(2), §183, Uniform Trust Code §803, Bogert’s Trusts and Trustees, Ch. 26 § 541

74 Treas. Reg. §25.2514-1(b)(1)

75 For a recent case “piercing the trust veil” by creditors where a son inherited funds from his deceased mother in a spendthrift trust, because he could appoint himself sole trustee, see In re Heifner, 2012 Bankr. LEXIS 3032 (Bankr. N.D. Ohio, 2012), also see separate trust piercing cases in author’s separate asset protection CLE outlines. As a whole, practitioners are woefully unaware of the different standards bankruptcy courts use for piercing trusts (or domestic relations courts for counting). For a case of surviving spouse/trustee not only losing the inheritance through mismanagement, but also losing bypass trust benefits, see Estate of Wendell Hester v. U.S. (4th Cir. 2008).
therefore immune to any such argument. However, the regulation cited above probably provides ample cover for surviving spouses as sole trustees. There are other various reasons that LPOAs and the Delaware Tax Trap should be considered discussed later in this article.

f. Variations to Accommodate Separate State Estate and Inheritance Taxes

We do not want inclusion in the federal estate, even if it causes no estate tax, to also inadvertently increase state estate tax, unless there is a greater overall income tax benefit.\(^{76}\) Consider the extremes: we do not want to grant a GPOA over stock bought at $95 rising to $100 at date of powerholder’s death to save $1 or so in potential capital gains tax savings if the state estate tax incurred on the $100 is $16! Clients in those states may have a $1 of $2 million state estate tax exempt trust and up to $3.25 or $4.25 million state-QTIPed trust. Obviously the latter is first choice to cull any basis from by inclusion in the beneficiary’s estate, since it would not cause any additional state estate tax.\(^{77}\)

Conversely, assets with a lot of gain may benefit from an increase despite any state estate tax. With the exception of Washington, most states that have estate tax also have a substantial state income tax, so that savings should be considered as well. The gold in the example above might be said to benefit from $40,000 or so of savings by increased basis ($100,000 gain time 31.8% federal, 8.2% net state income tax), as opposed to perhaps $24,000 or so in state estate tax loss ($200,000 inclusion times 12% rate). Again, this can be accomplished with a formula to ensure that increases to the estate are only made to the extent that the value of the step up exceeds the cost of the extra state estate tax.

Practitioners in states with a $1 million or less estate tax exemption may opt for simplicity of drafting/administration and simply forego the GPOA over any state-estate tax exempt trust property, since the savings may not be as great. However, surviving spouses may change residence or the applicable state tax regime may change (as it has recently in

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\(^{76}\) Ohio’s former estate tax, eliminated this year, failed to catch the Delaware Tax Trap (R.C. §5731.11), but most states piggy back onto the federal estate tax inclusion criteria.

\(^{77}\) While most states with an estate tax use the same criteria as the federal estate tax and Form 706 as their base, this is necessarily state specific. Pennsylvania’s inheritance tax, for example, does not tax a general power of appointment (or limited power of appointment triggering the Delaware Tax Trap) as the federal estate tax would. See [http://www.pacpa.org/Content/Files/Documents/Resources/Presentations%20and%20Brochures/6545-Inheritance%20Tax%20Brochure.pdf](http://www.pacpa.org/Content/Files/Documents/Resources/Presentations%20and%20Brochures/6545-Inheritance%20Tax%20Brochure.pdf). This creates a great loophole for Pennsylvania residents (which should be discussed with anyone planning to otherwise leave assets directly to a Pennsylvania resident).
Ohio, Indiana Minnesota and other states). Some states have larger exemptions of $2 million, $3.5 million or more that make it more compelling.

Practitioners may want to modify their formula with something similar to soak up available state estate tax exclusion, and then limit appointive assets also subject to state estate tax. For example, only “collectible assets with basis 70% or lower than fair market value at date of death, real estate with basis 60% or lower, or any other asset with a basis 50% or lower.” The above percentages are approximations and clients and practitioners may deviate from these considerably, but the concept is to create some greater threshold for inclusion if state estate tax were to be paid. Some clients may prefer to forego a basis increase at second death altogether if a 12-19% state estate or inheritance tax were incurred, on the theory that any capital gains tax can theoretically remain unrealized until the beneficiary’s death and receive an additional step up. Depreciable assets may be preferred as appointive assets due to the ability of additional basis to decrease current taxation.

Practitioners in states with an estate/inheritance tax should consider whether to modify any formula to account for out of state real estate or tangible personal property. Some states’ tax regimes exempt such assets from tax altogether, in which case you would want any GPOA (or LPOA appointment triggering the DTT) to apply to those assets first without fear of causing additional state transfer tax.78

Other states apply a convoluted percentage to tax out of state real estate and tangible property (it smells unconstitutional, but it would probably be upheld). For example, a taxpayer has $3 million estate, $1 million is out of state real estate and the state has $2 million exemption. Rather than interpreting this as a $2 million net estate for state tax purposes, resulting in $0 tax, this may result in a $3 million estate, tentative tax of $150,000, reduced by 1/3 due to the percentage of estate that is out of state property, or $100,000. Would a client (or his beneficiaries) want to pay a reduced state estate tax to gain additional basis? Again, it would depend on the nature of the asset, likely use in the hands of the beneficiary and its appreciation, but it becomes a closer call if state tax is reduced.

78 Although the situs state may have its own separate tax, this is unlikely to be an issue because most taxpayers who have real estate/tangible property out of state over a state’s exemption amount (usually $1, $2 or $3.5 million), will have such assets in an LLC. However, some states such as Maine may attempt to tax that as well. See description of Pennsylvania tax in footnote above for example of state that does not tax out of state property.
g. **Crafting GPOAs to Keep Fidelity to the Estate Plan and Preserve Asset Protection**

This brings us to the second perceived drawback of such planning – the potential thwarting of an estate plan by the inclusion of a testamentary general power of appointment. Remember that the IRS has historically bent over backwards to construe a GPOA, because in the past it produced more revenue than a more restrictive interpretation.79 Thankfully, we have a broad statute, regulations and many tax cases on which to rely, as well as favorable law in the asset protection context, so that GPOAs may pose little threat to the estate plan if properly constructed.

If the GPOA marital deduction is claimed, any GPOA must include the spouse or spouse’s estate, not just creditors, and must be “exercisable by such spouse alone and in all events”.80 However, if no marital deduction was claimed, as we aim to do in an Optimal Basis Increase Trust, the following limitations may be included:

A GPOA may limit the scope of eligible beneficiaries so long as creditors of the powerholder are included. For example: “I grant my beneficiary the testamentary power to appoint to any of my descendants [or to any trust primarily therefore, which is usually an option for trusts not designed to qualify as a “see through accumulation trust” for retirement benefits].”81 My beneficiary also may appoint to creditors of his or her estate.”

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79 Like horseshoes and hand grenades, you only have to be close. Someone does not have to know the extent of their power or even if they have one – if you give a mentally incompetent person or a minor a GPOA they don’t even know or can’t do anything about, it’s still a GPOA for tax purposes. A surprising number of appellate cases address these issues, all finding GPOAs, even if someone is incompetent and even if a state court appointed guardian could not exercise the GPOA. *Fish v. United States*, 432 F.2d. 1278 (9th Cir 1970), *Estate of Alperstein v. Commissioner*, 613 F.2d 1213 (2nd Cir 1979), *Williams v. United States*, 634 F.2d. 894 (5th Cir. 1981), *Boeving v. United States*, 650 F.2d. 493 (8th Cir. 1981), *Doyle v. United States*, 358 F. Supp. 300 (E.D. Pa 1973), *Pennsylvania Bank & Trust Co. v. United States*, 451 F. Supp. 1296 (W.D. Pa. 1978), aff’d 597 F.2d 382 (3rd Cir. 1979), *Estate of Alperstein v. Commissioner*, 71 TC 351 (1978), aff’d 613 F.2d. 1213 (2nd Cir 1979), *Estate of Freeman v. Commissioner*, 67 T.C. 202 (1979). See also Rev. Ruls 75-350, 75-351.

80 IRC §2056(b)(5), Treas. Reg. §20.2056(b)(5)(g) – though generally the whole purpose of the OBIT is to avoid forcing the marital, it’s important to remember. This language is also why you can’t simply let 5% of a GPOA lapse every year to let the marital trust escape estate tax altogether after 20 years or so.

81 Accumulation trusts should exclude any IRA distributions from being appointed in further trust, since by default powers of appointment generally permit appointments in further trust, which may jeopardize a “see through” trust. Restatement, Third, Donative Transfers, ¶19.13 and ¶19.14, Uniform Power of Appointment Act, §305

82 IRC §2041(b)(1) is in the disjunctive “or”. See also *Estate of Edelman v. Commissioner*, 38 T.C. 972 (1962), *Jenkins v. U.S.*, 428 F.2d 538, 544 (5th Cir. 1970). As for spouse’s POAs, see also Rev. Rul. 82-156 in accord. PLR 8836023: "In the present case, the descendants of the trustor who are the beneficiaries of the trust will be given a testamentary power to appoint to the creditors of the beneficiaries estates or to the beneficiaries' own descendants, or partially in favor of one or more persons from both classes of beneficiaries. The power of appointment that will be given to the beneficiaries will be a general power of appoint because they have a power to
Furthermore, a power is still a GPOA if it may only be exercised with the consent of a non-adverse party.\textsuperscript{83} Who is “adverse”? Generally, it is someone with a present or future chance to obtain a personal benefit from the property – not all beneficiaries would always be adverse.\textsuperscript{84} The jurisprudence is strongly in favor of finding parties to be non-adverse. In one Revenue Ruling, even a child who was a clear default remainder beneficiary of a trust was not considered adverse to her mother, who had a power to appoint to herself with permission of her child. Why? Because the child could have been divested via mom’s special testamentary power of appointment, making her insufficiently adverse!\textsuperscript{85}

Surprisingly, even a trustee with fiduciary duties to beneficiaries who would clearly be adverse is not considered adverse itself.\textsuperscript{86} For example, one might add to the above: “However, my beneficiary may only exercise said appointment with the consent of [name of non-adverse party, and/or] my trustee.” It is unclear whether a beneficiary/trustee would be adverse – for planning purposes, assume it could be either. Therefore if you name a trustee as an intended non-adverse consenting party, then make sure the trustee is not a beneficiary, and perhaps insert provisions to enable appointment of a non-adverse party as trustee if, for instance, a beneficiary were the successor trustee (and adverse) and the beneficiary actually attempted to appoint to their creditors. If you name a non-adverse party, make sure to name alternates in the event the first is deceased or incapacitated. In theory, one could name multiple non-adverse parties necessary for unanimous consent, but pushing that envelope is hardly necessary.

\textsuperscript{83} IRC §2041(b)(1)(C)(ii), Treas. Reg. §20.2041-3(c)(2) As for spousal POAs, see also Rev. Rul. 82-156.

\textsuperscript{84} Paraphrasing Estate of Towle v. Commissioner, 54 T.C. 368 (1970). To be adverse, the party must have a “substantial interest in the property subject to the power which is adverse to the exercise of the [GPOA]”. A taker in default of appointment has an adverse interest. An interest is adverse and is considered substantial if its “value in relation to the total value of the property that is subject to the power is not insignificant and is valued in accordance with the actuarial principles of Treas. Reg. §20.2031-7”. Treas. Reg. §20.2041-3(c)(2).

\textsuperscript{85} Rev. Rul. 79-63 – a dubious ruling in light of Treas. Reg. §20.2041-3(c)(2), but you can rely on it if you keep your facts close, unlike a PLR.

\textsuperscript{86} An independent bank co-trustee, for example, is not sufficiently adverse. Estate of Vissering v. Commissioner, 96 T.C. 749 (1971), reversed on other grounds, Estate of Jones v. Commissioner, 56 T.C. 35 (1971), Miller v. United States, 387 F.2d 866 (1968). Treas. Reg. §20.2041-3(c)(2), Example 3. However, I prefer naming other non-adverse parties rather than trustees for simplicity in drafting and potentially asset protection differences (might a rogue court compel trustee acquiescence based on indirect fiduciary duty?)
Furthermore, a GPOA is “considered to exist on the date of a decedent's death even though the exercise of the power is subject to the precedent giving of notice, or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the decedent's death notice has been given or the power has been exercised.”\textsuperscript{87} This offers even more opportunity to make GPOAs more difficult to actually exercise, yet still come within the safe harbor of a treasury regulation.

If there is a qualified plan or IRA payable to the trust designed to be a see through trust (specifically, an “accumulation” trust, it would not be necessary for a “conduit” trust), one might consider a further restriction to prevent disqualification – “to creditors who are individual persons younger than my beneficiary” (a technique seemingly blessed by a recent PLR that permitted such a circumscribed GPOA to retain see through trust status).\textsuperscript{88} Although the OBIT techniques herein to increase basis would not apply to IRAs or qualified plans,\textsuperscript{89} you may have a GST non-exempt share over which a GPOA is desired. It would probably be preferred to use a conduit trust, but if for some reason that is undesirable, there may not be a lot to lose in circumscribing the GPOA in this manner as applied to such a trust.

Generally, I would not attempt to limit a GPOA in this manner for any non-standalone IRA accumulation trust – requiring appropriate non-adverse parties’ consent should be more than adequate to prevent unwanted exercise. Although I could find no discussion in any restatement, case or otherwise, a reasonable interpretation might be that an attempted GPOA relying on the ability to appoint to creditors must include commonly found creditors to avoid being illusory. That said, it may still be prudent to limit the power to appoint to creditors to the amount of the \textit{legally enforceable} debt and to reasonably equivalent value for contractual debt. Otherwise, a powerholder could in theory borrow $1 from anyone and/or

\textsuperscript{87} Treas. Reg. §20.2041-3(b)
\textsuperscript{88} See PLR 2012-03033, and discussion thereof in separate IRA “see through trust” checklist CLE materials developed by author. This PLR addressed the effect of a release creating such a limitation for “see through trust” purposes of identifying the oldest beneficiary applicable, but it did not discuss whether, after such a limitation, the power was still a GPOA and what the later tax effects might be. Pursuant to the plain language of the statute and Regs, it is still a GPOA, but at some point you have to wonder whether the IRS would argue such GPOAs are illusory – how many \textit{creditors} out there are young individuals? While this trick is probably not good practice for drafting new GPOAs, the counsel submitting this PLR were quite clever and successfully threaded the needle – although the IRS did not rule on that aspect in the PLR, the GST tax will probably still be avoided, because either the remaining power or the completion of the gift caused by the release at death will cause estate inclusion.
\textsuperscript{89} IRC §1014(c), IRC §691
promise to pay unlimited amounts in exchange for some peppercorn of valid consideration to enable an appointment of all the assets to whomever they wished.\textsuperscript{90}

In addition, any “consent” provision should ensure that there are backups and defaults to ensure that the consenting party has a bona fide ability to act.\textsuperscript{91} This would entail naming alternates (my recommendation) and/or allowing a trustee, trust protector or local court to appoint a non-adverse consenting party (which might be a co-trustee). For example, if there is no way the "consenter" COULD consent, and the default in its absence were to deny the appointment, then the IRS may have an argument (albeit weak, considering the precedent) that there was no GPOA. What if a child who would be an adverse party is trustee or co-trustee and never gets around to appointing a non-adverse trustee? What if the non-adverse party is dead or incapacitated, renounces (or worse, disclaims) their power to consent, or is simply never informed of the existence of their consent power, or never returns the trustee’s phone calls, letters, emails (all very possible)? Those problems can be drafted around. For instance, the document can permit an agent/guardian to act for incapacitated "consenter", you can name alternates, and, of course, you should probably have the default be to ALLOW exercise rather than deny it.

For instance, a default might be to allow the decedent’s GPOA to be exercised unless a written acknowledgment of the "consent" power is received from a "consenter", or the trustee has actual knowledge that the consenter has been informed, within so many months. Then you would need language to allow agent/guardian consent, and language to trigger or even appoint an alternate "consenter" under certain circumstances. You could have mere receipt of acknowledgment deny the effectiveness of the GPOA unless consent is timely granted, or draft it as a veto power. Then you have a "default" of sorts that makes it clear that the GPOA is never illusory. Careful drafting can ensure it is clear that the capability of exercise is always there.

\textsuperscript{90} Actually, the Restatement, Third, Donative Transfers, §19.2 discusses the concept of a “fraud upon the power” as voiding any shenanigans to circumvent the intention of the creator of the power by attempting to appoint to impermissible beneficiaries, so extreme manipulations would probably not succeed anyway, but why tempt it?

\textsuperscript{91} It is unclear whether a “consenting party” would be as liberally found as a GPOA powerholder, logically it should follow the jurisprudence cited in footnote 56 above, but, like 	extit{Crummey} powers, why not be safe and ensure the power is acknowledged? See Rev. Rul. 81-7 for the IRS take on present interests— but the IRS consistently loses cases in this area even with shoddy trust administration, and it is a completely different statute.
h. **Could testamentary GPOA assets be subject to creditors of an insolvent powerholder’s estate, or subject to state spousal elective share statutes?**

While only a handful of states have specific state law impacting creditor access to testamentary GPOAs, common law is generally quite favorable as to whether and when a testamentary general power of appointment subjects the appointive assets to the donee powerholder’s creditors. 92 In bankruptcy the assets are clearly not subject to creditors. 93 It may depend on whether the power is exercised or whether it is merely allowed to lapse.

Here are three sources with the general rules. The third citation is from an attempt by the National Conference of Commissioners on Uniform State Laws (NCCUSL) to steer state law to a more creditor-friendly position. It has only been passed in one state, Colorado, but is being introduced in three more as of Sept 2014:

§ 13.2 Creditors of the Donee -- Unexercised General Power Not Created by Donee.
Appointive assets covered by an unexercised general power of appointment, created by a person other than the donee, can be subjected to payment of claims of creditors of the donee, or claims against the donee's estate, **but only to the extent provided by statute.**

§ 13.4 Creditors of the Donee -- General Power Exercised by Will.
Appointive assets covered by an exercised general power to appoint by will, created by a person other than the donee, can be subjected to the payment of claims against the donee's estate.

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92 For a creditor-friendly state, see Cal. Prob. Code §682(b): “Upon the death of the donee, to the extent that the donee’s estate is inadequate to satisfy the claims of creditors of the estate and the expenses of administration of the estate, property subject to a general testamentary power of appointment … is subject to the claims and expenses to the same extent that it would be subject to the claims and expenses if the property had been owned by the donee.”


94 *Restatement of Property, Second, Donative Transfers, §13.2*

95 *Restatement of Property, Second, Donative Transfers, §13.4*
§ 502. CREDITOR CLAIM: GENERAL POWER NOT CREATED BY POWERHOLDER.

(a) Except as otherwise provided in subsection (b), appointive property subject to a general power of appointment created by a person other than the powerholder is subject to a claim of a creditor of: ****(2) the powerholder’s estate, to the extent the estate is insufficient, subject to the right of a decedent to direct the source from which liabilities are paid. [subsection (b) refers to HEMS standards, i.e., nongeneral powers]96

Surprisingly, the Uniform Probate Code also seems protective of testamentary GPOAs as against non-spousal creditors.97 If your state law is unfavorable to debtor/decedents holding testamentary GPOAs, like California, it may be preferable to use the Delaware Tax Trap technique if there is a fear that a power holder’s estate may be exposed to lawsuits or insolvency. This technique uses limited powers of appointment only. Alternatively, limit the testamentary GPOA should the powerholder’s estate be insolvent.98

In other states, a specific statute, like the Rhode Island or Alaska statutes cited above, may give comfort.

Most states probably currently follow the common law elucidated by §13.2 of the 2nd Restatement cited above, which gives protection to insolvent power holder estates where the power remains unexercised.99 But three concerns may still arise even for these states:

1) what if the state subsequently passes the Uniform Power of Appointment Act (UPAA)? If your state is debating the UPAA, it may be an opportunity to amend §502 prior to

96 Uniform Power of Appointment Act, §502 at www.uniformlaws.org, based largely on Restatement, 3d, §22.3. It has only been passed in one state, Colorado, but is being introduced in three more as of Sept 2014
97 See Uniform Probate Code §6-102, comment 3: “The definition of ‘nonprobate transfer’ in subsection (a) includes revocable transfers by a decedent; it does not include a transfer at death incident to a decedent’s exercise or non-exercise of a presently exercisable general power of appointment created by another person. The drafters decided against including such powers even though presently exercisable general powers of appointment are subject to the Code’s augmented estate provisions dealing with protection of a surviving spouse from disinheritance. Spousal protection against disinheritance by the other spouse supports the institution of marriage; creditors are better able to fend for themselves than financially disadvantaged surviving spouses. In addition, a presently exercisable general power of appointment created by another person is commonly viewed as a provision in the trust creator’s instrument designed to provide flexibility in the estate plan rather than as a gift to the donee.”
98 See discussion of PLR 9110054 in section III.m. below and sample clauses in appendix
99 Some states may have related case law not even in the Restatement, such as the Ohio Supreme Court’s decision in Schofield v. Cleveland Trust Co., 21 N.E.2d 119 (Ohio 1939), protecting non-probate trust assets from probate estate creditors
passage, as many states did with various provisions of the Uniform Trust Code. Colorado, the only state to have passed the Act, omitted the entire Article concerning creditor rights.100

From a practical and public policy standpoint, a testamentary general power is quite different from outright ownership, especially if there are various limitations and constraints on the power, such as non-adverse party consent requirements, as discussed herein.

2) Which state law applies and what if the donor and donee of the power are different? If the donee power holder changes state of residency? For instance, from Rhode Island to California. Which state’s debtor/creditor law applies to the power of appointment, the donor or the donee of the power? The new UPAA attempts to change the common law in this regard. At common law, the applicable law of the donor applied, but under the UPAA, the applicable law of the state of the donee will apply, but the UPAA may not necessarily apply to both states. Can this be changed? Can we import or declare a particular state law to apply and would it hold up as against creditors? No one wants a messy conflict of law or federal dispute if it can be avoided.

3) What if the power holder actually exercises the power? Even if it is exercised in favor of non-creditor appointees, such as children or charities, this may trigger the application of the common law rule in Restatement Second ¶13.4 discussed above. There are various instances where a power holder will not just want a power to lapse, but exercise it - either for dispositive reasons, asset protection reasons or even grantor trust differences.101

Since future law is always uncertain, as well as the residency of the powerholder, and whether the powerholder might exercise, it may be prudent to take several steps to mitigate against these risks when drafting testamentary GPOAs:

1) Allow a trustee or trust protector to amend according to changes in circumstance (as discussed elsewhere herein, see sample clauses outlining reasons).

2) Limit the scope of the power by creating a prerequisite, cap or threshold preventing GPOAs for substantially insolvent estates. By “substantially insolvent”, if the power holder’s estate is insolvent by $10, such that a creditor could seize

100 http://tornado.state.co.us/gov_dir/leg_dir/olls/sl2014a/sl_209.htm (Part 5, which would be Article 5 of the UPAA, being “reserved”)
101 Part V.h. discusses the grantor trust differences of exercise/nonexercise under §1.671-2(e)
only $10 of assets subject to the power holder’s GPOA, would you want to void the GPOA entirely, forgoing up to $5.34 million of basis to thwart a $10 debt? I suggest preventing a GPOA only where the cost outweighs the benefit. The clause might only be activated if UPAA §502, Ca. Prob. Code §682(b) or equivalent is applicable.

3) Draft limited and general powers separately, so that the GPOA does not allow appointment to anyone but creditors. Would exercising a limited power to appoint to children/trust be deemed an exercise of a GPOA under state law where a concurrent GPOA exists? I am uncertain as to the answer – the exercise of an LPOA when a GPOA also exists may be deemed to be an exercise of the GPOA even if they are in separate paragraphs, but it certainly can’t hurt to separate into two powers.

4) Require consent of a non-adverse party or parties to enable exercise of a GPOA.

**Spousal Elective Share Rights**

Various speakers at Heckerling and other conferences may have scared attendees into believing that third party-created formula testamentary GPOAs risk invoking spousal statutory share rights should the surviving spouse remarry (or, in the event another downstream beneficiary has a similar testamentary GPOA). This does not appear to be the case. Despite the false alarms on this issue, you might circumscribe the formula GPOA to prevent application if the powerholder were to move to a state that later enacts a new statute that goes beyond the current state of the law to include such third-party created testamentary GPOAs. Some might simply ignore this in drafting the formula GPOA as

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102 See various clauses in appendix
103 E.g., comments by Paul Lee, Jeff Pennell, as well as other Heckerling comments that they are “too complicated”
104 See Uniform Probate Code § 2-205(1)(A), with Example 1 in the UPC commentary precisely on point. This section is unaffected by the 2008 proposed amendments to the UPC. It contrasts with presently exercisable or self-created powers. While I did not research all states, I have yet to find one that would bring third party created testamentary powers into an augmented estate, unless they were accompanied by presently exercisable GPOAs, which would be rare and certainly not recommended herein. Many state statutes, like Ohio’s which only applies to probate estate assets, have holes in them wide enough to drive a truck through, but even those non-UPC states with broadly inclusive statutes exclude such appointive assets. E.g. see Fla. Stat. 732.2045(h), N.Y. EPTL §5-1.1-A(b)(1)(H) and citations in ACTEC’s 2004 survey of state spousal elective share statutes, including non-UPC states, at [http://www.actec.org/resources/publications/studies/study10.pdf](http://www.actec.org/resources/publications/studies/study10.pdf). I welcome any corrections if there is a state out there holding otherwise.
currently a “non-issue”, but note the settlor’s concern about future legislation expanding the spousal elective share in any statement of material purpose or trust protector or amendment clause that outlines the scope of potential future amendments, such as the example in the appendix.

Effect of Formula Testamentary GPOAs on Prenuptial and Postnuptial Agreements

While you may be able to avoid third party creditor issues either by residing outside of CA, not exercising the GPOA, or through drafting, and spousal elective share statutes are unlikely the issue some think it is, you should still examine any pre/post nuptial agreements or contracts to make a will that might affect property rights/division based on a contracting party’s “taxable estate”, which could conceivably be overly broadly defined so as to include such assets. A pre or post nuptial agreement might easily have a much broader definition of estate than a state spousal elective share statute. For example, what if a pre/post nuptial agreement provides that a spouse is to receive 1/3 of the other spouse’s taxable estate and their parent (or child or some other settlor as contemplated in Part V) has granted that spouse a formula testamentary general power of appointment? A well-drafted contract would probably exclude such assets, but it merits careful examination nonetheless.
i. Using the Delaware Tax Trap Instead of a GPOA to Optimize Basis

In our examples of John and Jane Doe above, we presumed that the Optimal Basis Increase Trust used a formula GPOA to cause estate inclusion and increased basis. However, there is also a technique to accomplish the same result with a limited power of appointment. This involves IRC §2041(a)(3), colloquially known as the Delaware Tax Trap (“DTT”).105

“(3) Creation of another power in certain cases
To the extent of any property with respect to which the decedent—
(A) by will, or
(B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent’s gross estate under section 2035, 2036, or 2037, exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.”

The application of this rule, in conjunction with various states’ rules against perpetuities, is complex. While many states have enacted “savings clauses” into their statutes (or passed a Uniform Act) that has closed off the ability of an LPOA to trigger this in most instances, there is one method usually left out of these savings statutes, and that appears to be available in most states. I will refer the reader to more learned articles on the subject, and concentrate on the method of triggering §2041(a)(3) which is the most likely to be available in the vast majority of states.106

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105 See also Treas. Reg. §20.2041-3(e). There is a gift tax analog, §2514(e), but triggering gift tax only increases basis to the extent of gift tax actually paid, so this paper will primarily discuss the estate tax variant.

106 See Howard Zaritsky’s ACTEC compilation 50 State and D.C. Survey of Rule Against Perpetuities Law, specifically pages 8-10: http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf. There is also good discussion in Estate of Murphy v. Commissioner, 71 T.C. 671 (1979) (analyzing an LPOA appointment to a trust that contained another LPOA and finding under Wisconsin rule against perpetuities law §2041(a)(3) was not triggered). See also Using the Delaware Tax Trap to Avoid Generation Skipping Transfer Taxes, Jonathan Blattmachr and Jeffrey Pennell, 68 Journal of Taxation 242 (1988), available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954062. While the DTT was not considered or discussed for this type of planning, this is not the fault of two of the sharpest estate and tax planning minds in the country, rather, the exclusion was only $600,000 at the time. See also A Practical Look at Springing the Delaware Tax Trap to Avert Generation Skipping Transfer Tax, James P. Spica, 41 RPTL Journal 167, Spring 2006; The Delaware Tax Trap and the Rule Against Perpetuities, Stephen Greer, Estate Planning Journal Feb 2001. Revising the RAP, Patricia Culler, Probate Law Journal of Ohio, March/April 2012.
Generally, if Jane in our example had a *limited* power of appointment which permitted appointment in further trust, and Jane appointed those assets to a separate trust which gives a beneficiary a *presently exercisable* general power of appointment (often referred to as a “PEG power”), this would trigger §2041(a)(3), cause estate inclusion, and therefore an increased basis under IRC §1014, just as a standard GPOA would.\(^{107}\)

Thus, Jane’s Will (or trust or other document, if permitted by John’s trust) would appoint any appreciated assets to such a “Delaware Tax Trapping” trust as discussed in the above sections, and other assets outright or to another ordinary trust. Treasury Regulations outline examples of specific, partial and targeted use of the Delaware Tax Trap (“DTT”) as this article recommends:

> “Thus, if a decedent has a power to appoint by will $100,000 to a group of persons consisting of his children and grandchildren and exercises the power by making an outright appointment of $75,000 and by giving one appointee a power to appoint $25,000, no more than $25,000 will be includable in the decedent’s gross estate under section 2041(a)(3).”\(^{108}\)

In drafting mode, using the DTT is probably not an optimal strategy to employ for John’s trust, because it will necessarily require Jane to draft a new Will/Trust invoking the LPOA and a new appointive trust with terms that one would ordinarily avoid. Giving a beneficiary a presently exercisable GPOA impairs asset protection much more than a testamentary power, and destroys any chance of spraying income or making tax-free gifts, nor does it allow avoidance of state or federal estate taxation or avoidance of a step down in basis at the child’s death.\(^{109}\)

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\(^{107}\) See discussion in ACTEC survey and articles cited in the above footnote. All of which conclude that this should trigger §2041(a)(3) under most states’ RAP. This seems counterintuitive for a tax provision that is intended to attack delayed vesting and avoiding transfer tax, since a beneficiary holding a typical PEG power appears the *de facto* owner and would not be “GST-exempt” absent further planning, but that is the conclusion of many accomplished authors and Treasury’s own examples. Could a power of appointment be crafted under state law so as to trigger a new vesting period and §2041(a)(3), yet not be a GPOA under §2514/§2041 or state creditor protection law, such as a power limited to ascertainable standards, or a power only exercisable with the consent of an adverse party? Probably *not*, because this would not be “presently exercisable”, which under common law means it must not be conditioned on the occurrence of a specified event, the satisfaction of an ascertainable standard, or the passage of a specified period of time. *Restatement Property, 3rd, Donative Transfers*, §17.4.

\(^{108}\) Treas. Reg. §20.2041-3(e)(2). There is a near identical gift tax regulation at Treas. Reg. §25.2514-3(d).

\(^{109}\) Contrast lifetime GPOAs in *Restatement of Property, Second, Donative Transfers*, §13.2 and §13.5 with the testamentary variations in §13.4 (state law), §13.6 (bankruptcy). Whether it’s a testamentary or lifetime (presently exercisable) GPOA makes a huge difference in bankruptcy. See 11 U.S.C. § 541(b)(1).
With all of the above negatives, using the DTT to harvest the basis coupon probably has more realistic application in the context of preexisting irrevocable trusts that already contain an LPOA, as discussed in Part VII, and should probably not be used in planning mode to accomplish optimal basis adjustments, especially since many practitioners and clients rely on disclaimer funding, which kills the LPOA necessary for a DTT (unless limited as discussed in Part IV). However, if the trust for children pays outright anyway, and no disclaimer funding is anticipated, this route may be the easiest, and most flexible, to take.

j. **Drafting Alternatives to Curb the “PEG Power” yet still trigger §2041(a)(3)**

Practitioners might even craft a lapsing “Crummey” power into the appointive trust so that if the GPOA lapses, assets flow into a self-settled, incomplete gift domestic asset protection trust with situs in Ohio, Delaware or one of the other dozen or more permitted states. As with Crummey powers, a portion may “hang”, or various non-PEG powers may be retained to avoid any completed gift by the lapse. My personal preferred route would be to avoid “baking in” the DAPT, but to instead strongly encourage such an appointment and to mandate that trust funds be used to pay attorney fees and/or trustee set up fees associated therewith. It may also be possible to use non-voting, restricted LLC/LP shares to effectively curb a spendthrift beneficiary, and use the 5% lapse protection to effectively “freeze” the estate as to PEG powerholder’s appointive assets over time.110

Another counter-intuitive technique a powerholder may use to trigger the DTT, but still protect from an improvident or spendthrift beneficiary would be to only grant the beneficiary a lifetime income interest coupled with a “presently exercisable” GPOA over **only the remainder interest**. This is still deemed a “presently exercisable” GPOA.111 In an earlier version of this article, I had initially opined that this technique would probably cause only partial inclusion based on actuarial value of the remainder. I was wrong, and it is clear that a step up in basis over the 100% of the appointed assets is available:

”(2) For purposes of the application of section 2041(a)(3), the value of the property subject to the second power of appointment is considered to be its value unreduced by any precedent or subsequent interest which is not subject to the second power.

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110 IRC §2514(e) – the so called “5 and 5” lapse protection.
111 See Restatement Third Property, Wills and Other Donative Transfers, §17.4, comment a, illustration 1, and draft Uniform Power of Appointment Act, §102, comments re ¶14. It is not testamentary because the powerholder can make an irrevocable transfer of the remainder, effective immediately.
Thus, if a decedent has a power to appoint by will $100,000 to a group of persons consisting of his children and grandchildren and exercises the power by making an outright appointment of $75,000 and by giving one appointee a power to appoint $25,000, no more than $25,000 will be includable in the decedent’s gross estate under section 2041(a)(3). **If, however, the decedent appoints the income from the entire fund to a beneficiary for life with power in the beneficiary to appoint the remainder by will, the entire $100,000 will be includable in the decedent’s gross estate under section 2041(a)(3)** if the exercise of the second power can validly postpone the vesting of any estate or interest in the property or can suspend the absolute ownership or power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.”

Remember that you cannot use a non-adverse party consent if the goal is also to qualify the DTT/estate triggering for the marital deduction. Such an appointment would be rare, however, since LPOAs usually exclude subsequent spouses as potential appointees, but it is certainly possible, especially in a trust for children where a parent may want some limited flexibility not to impoverish their son or daughter in law. In such case the powerholder could appoint to a Delaware Tax Trapping GPOA marital trust for the surviving spouse getting a full step up without causing estate tax or even using a dime of applicable exclusion amount – this may be an advantage of LPOA/DTT over formula GPOAs, or at least the more conservative form of them recommended herein – see discussion below. It is unclear whether adverse or non-adverse party consent would preclude a GPOA PEG power from being “presently exercisable” and triggering the DTT.

The formula GPOA would be more advantageous than using the PEG/DTT because of better estate/gift/GST sheltering, ability to spray income, and superior third party settled trust protection, but using the PEG/DTT techniques can offer substantial protections and advantages nonetheless. Ideally, states will amend their Rule Against Perpetuities statutes to permit opting in to a regime that would allow LPOAs creating further LPOAs to trigger the DTT, obviating the need to use PEG powers.113

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112 Treas. Reg. §20.2041-3(e)(2), there is a nearly identical gift tax regulation at §25.2514-3(d)
113 See [http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf](http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf), ironically, even Delaware has foreclosed this use for GST exempt trusts, the very situations where it will now most often be useful. According to the survey, Kentucky and Wisconsin have the most useful statutes (or, depending on the point of view, treacherous, if dealing with an inadvertent appointment and taxable estates), in that appointing to a trust that grants a testamentary GPOA can also trigger 2041(a)(3), which would at least improve upon the asset protection/control issues.
k. Amending or Crafting Delaware Tax Trap Savings Clauses

Practitioners may legitimately fear that the Delaware tax trap might be triggered accidentally, over assets that would get a step down in basis, or worse, over so many assets that additional estate tax is caused. The latter, of course, has been the concern historically. This is why most states have closed the loophole except in the case of a PEG power. Some trust documents attempt to close the DTT altogether, including what the states would otherwise allow, so that any attempted appointment triggering the DTT would be null and void (aka “a fraud upon the power”). Here is one example:

"My beneficiary may not exercise this testamentary limited power of appointment to create another power of appointment that, under the applicable local law, can be validly exercised in order to postpone the vesting of any estate or interest in this property for a period ascertainable without regard to the date of the creation of the first power."

This prevents using an LPOA to appoint to a trust with a PEG power. However, we should not completely foreclose the use of the DTT in our trusts. It’s like using a sledgehammer to swat a fly. We should merely prevent the inadvertent exercise that triggers estate tax (or more estate tax than is saved in income tax). Therefore, we could modify the above with something like:

“Unless my beneficiary specifically indicates an intention to override this paragraph or for IRC §2041(a)(3) to apply to his or her exercise of the testamentary power of appointment granted herein, ....”

This requires an affirmative opting in by the power holder. Of course, you could also add a cap to this power, and a limitation on appointive assets subject to the, but a basic specific opt-in should be adequate protection. Limitations beyond this may be detrimental – as discussed above, there may be cases where triggering a small state estate tax is worth it to get a larger overall income tax benefit, or, Congress may one day lower the estate tax rate.

I. Addressing the Kurz case and other Potential Attacks on Formula GPOAs

Some practitioners may prefer using the Delaware Tax Trap for another reason altogether. They may fear that the surviving spouse’s control of his/her net estate value (either through spending, or by leaving assets to charity/spouse), may permit indirect control
of the value of the appointive assets in the bypass trust subject to the formula GPOA provision and hence could trigger over-inclusion.

Here is an example of the theoretical argument: John leaves Jane $4 million in a trust with a formula GPOA (optimal basis increase provision as discussed). She has $4 million of her own assets and $6.5 million applicable exclusion amount. At her death, John’s trust caps Jane’s GPOA at $2.5 million, based on her remaining applicable exclusion amount. Might the IRS argue, however, that Jane could have spent all her money, or left it to charity, thus de facto being able to control the disposition (i.e., GPOA) of all $4 million of John’s trust despite the fact that Jane has no power to control or direct the excess $1.5 million?

Formula funding/channeling clauses based on a surviving spouse’s available GST amount have been used for decades in GST non-exempt trusts without such specious arguments. Strangely, it seems the same commentators that laud or even use the technique for GST planning for the wealthy seem to disparage the idea for income tax planning for the mere upper-middle class.

What about trust protector provisions that allow adding/amending POAs? Could this ability somehow taint the tax effectiveness of the formula GPOA? Probably not, since POAs are deemed general or non-general based on their scope at the applicable time in question.115

m. PLRs 9110054, 9527024 – Approval of Formula GPOAs to Optimize GST/Estate Tax

The IRS has viewed very similar and arguably more complex formula GPOAs favorably. Unlike some PLRs, these appear to be on steady ground based on the regulations they cite. Although these clauses were used to cause estate taxation in lieu of GST taxation, the concept and issues are precisely the same. Let’s examine PLR 9527024 first:

“In addition, under Article IV-D-3 of the trust, a child who has a power of appointment exercisable by will may, by a will specifically referring to this power of appointment, appoint to his or her estate to the extent the aggregate of the federal estate and GST tax due as a result of the child’s death can be reduced. The amount of property subject to the power will be includible in the child’s gross estate under §2041. To the

114 See, e.g., Howard Zaritsky, Carol Harrington and Lloyd Plaine’s treatise Generation Skipping Transfer Tax, various forms channeling distribution of “the largest amount, if any, of my wife’s available GST exemption”. You can find multiple examples of such clauses online from CLEs done decades ago.

115 “If the settlor of a trust empowers a trustee or another person to change a power of appointment from a general power into a nongeneral power, or vice versa, the power is either general or nongeneral depending on the scope of the power at any particular time.” Comments to Uniform Power of Appointment Act, §102
extent the property is includible in the child's gross estate and subject to federal estate tax, the child will become the transferor of the property for GST purposes. Accordingly, as a result of Article IV-D-3, no GST tax will be due at a child's death (assuming that the child does not appoint the property to a skip person) unless and until the marginal rate of federal estate tax in the child's estate equals the GST tax rate (the maximum federal estate tax rate). The trust will not be subject to federal estate tax in the child's estate except to the extent inclusion of the property results in a reduction of the aggregate taxes.”

Like an OBIT clause, the efficacy and administration of this PLR’s GPOA depends and is blatantly relying on the power holder’s outside assets, estate plan and applicable exclusions.

PLR 9110054 has a similar formula GPOA, but is even more complex because the taxpayers were in California, which, as discussed in Section III.h. above, subjects testamentary GPOAs to the power holder’s estate’s creditors to the extent the estate is insolvent (hence the second paragraph quoted below). The pertinent discussion of the formula GPOA sanctioned in that PLR is below, with bold and bracketed language added:

“Under paragraph 7.3.3, in the event that the beneficiary of a Non-GSTT trust predeceases the full distribution of the trust estate, the beneficiary will have the power to appoint ("the Power") in favor of one or more of the creditors of the beneficiary and/or the creditors of the beneficiary's estate so much of the trust estate that may be undistributed at the time of the beneficiary's death as: (1) would otherwise be distributed to a "skip person" as defined in section 2613 of the Internal Revenue Code, with respect to X; and (2) does not exceed the Appointment Amount. Under paragraph 7.3.3.1 of the X Trust, the Appointment Amount is defined as the amount which is the lesser of (1) the portion of the trust estate which is not exempt from generation-skipping transfer tax or (2) an amount which, when added to the beneficiary's taxable estate (computed as if the Power had not been granted based upon values of the beneficiary's estate), will cause one dollar ($1.00) to be subject to federal estate tax in the beneficiary's estate at the highest tax rate then in effect as set forth in section 2001 of the Internal Revenue Code.

The X Trust also provides that, in the event that the liabilities of the beneficiary's estate exceed the value of its assets (based upon values as finally determined in the federal estate tax proceedings of the beneficiary's estate excluding the Power), no Power is granted unless the sum of (i) the federal estate taxes and state inheritance or estate taxes which would be payable by reason of the beneficiary's death computed as if the property appointable by the power had been included in the beneficiary's gross estate, (ii) the GSTT which would be payable from the trust by reason of the beneficiary's death computed as if the property appointable by the Power has been included in the beneficiary's gross estate for federal estate tax purposes, and (iii) the

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116 PLR 9527024
excess of the liabilities of the beneficiary's estate over its assets, excluding the Power shall be less than or equal to the GSTT which would be payable from this trust by reason of the beneficiary's death computed as if the Power had not been granted. California Civil Code section 1390-3(b) [note – this statute is the direct predecessor to California Probate Code §682, with similar import, discussed in Section III.h.] enables the creditors of the insolvent estate of a donee of a general power of appointment to reach the assets subject to such power. According to the taxpayer, the second part of the formula which calculates the extent of the X Trust over which the Power may be exercised is intended to nullify the Power if the net trust estate without the Power after payment of the GSTT, will exceed the net trust estate if the Power is granted to an insolvent donee, after reduction of estate taxes and payment of creditors. Even though the power is expressed in terms of a formula, the power meets the statutory definition of a general power of appointment because it is exercisable by the beneficiary alone in favor of one or more of the creditors of the beneficiary or the creditors of the beneficiary's estate, and the power is not limited by an ascertainable standard. We conclude therefore, that the power created by X under paragraph 7.3.3 of the X Trust is a general power of appointment within the meaning of section 2041(b) of the Code.

Under section 20.2041-3(b) of the regulations, a power which by its terms is exercisable only upon the occurrence of an event or contingency which does not in fact take place prior to the decedent's death is not a power in existence on the date of death. [note, this is the regulation interpreted by the Kurz cases discussed in Section III.n. below, and cited by some as a worry about formula GPOAs]

In the present case, the power of appointment is expressed as a formula:***

Under this formula there are contingencies that may result in the nonexistence of the Power upon the date of the beneficiary's death. If these contingencies do occur, that is, if the liabilities of a beneficiary's estate exceed the value of its assets and the taxes that would be payable if the Power had not been granted are less than if the Power had been granted, the Power will not be granted. In such a case, the beneficiary will not possess a power of appointment at the time of death. Although we do not know at this time whether the beneficiary will possess a general power of appointment at the time of the beneficiary's death, we can conclude that the amount of the X Trust property that will be includible in the estate of each donee of the Power, by reason of the Power will be the maximum amount over which the Power may be exercised pursuant to the provisions set forth above that are provided in Paragraph 7.3.3 and 7.3.3.1 of the X Trust.

PLR 9110054 is a rather clever formula GPOA that both minimizes the GST and estate tax when considered together, but also does not add a GPOA if it would otherwise jeopardize the power holder’s estate to creditors. The OBIT is in many ways an expansion on these formula GPOAs, but expanded to apply beyond GST non-exempt trusts for superior income tax
results. While the thrust of this OBIT white paper has been spouses and GST exempt trusts, the GST language in the trusts in the PLRs above might be considered in creating formula GPOAs for downstream beneficiaries, and, of course, any GPOAs over GST non-exempt trusts.

As cited elsewhere herein, Treasury has given examples of tax minimizing formula clauses in the QTIP and disclaimer realm, and regulations under 2041 and 2514 seem clear in the ability to cap or limit GPOAs as to specific assets. However, there is some facile plausibility to the argument and a case that on the surface appears to help it (or at least can confuse practitioners), so let’s distinguish the case, discuss why the “ballooning GPOA” argument has no merit, and how to easily avoid it anyway.

n. Addressing the Kurz cases Regarding Contingent GPOAs

In the *Estate of Kurz*, husband died leaving his wife a marital trust with an unrestricted lifetime GPOA, and if that were exhausted, a lifetime 5% withdrawal power over the bypass trust. The estate argued that the 5% power was not in the estate because of a condition precedent not being met. Treas. Reg §20.2041-3(b) provides that:

“A power which by its terms is exercisable only upon the occurrence during the decedent’s lifetime of an event or contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent’s death. For example, if a decedent was given a general power of appointment exercisable only after he reached a certain age, only if he survived another person, or only if he died without descendants, the power would not be in existence on the date of the decedent’s death if the condition precedent to its exercise had not occurred.”

However, *all the wife had to do was ask* for funds for the marital trust and she was entitled to the 5% from the bypass. It would not surprise any tax practitioner that both the tax court and the appellate court concluded that the wife held a GPOA - she could effectively access the 5% of the bypass trust *at any time, for any reason, without affecting her estate, during her lifetime.*

The tax court’s rationale was that the “contingency” was illusory and lacked any independent non-tax consequence or significance. The appellate court preferred a test that looked through the formalities to determine how much wealth the decedent actually had reached.

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117 *Estate of Kurz*, 101 T.C. 44 (1993), aff’d 68 F.3d 1027 (7th Cir. 1995) – I suggest reading both the district court and appellate court opinions, even though the latter is more controlling.
controlled at death. It looked to the examples in the regulation quoted above, and noted that those examples of contingencies were not easily or quickly controlled by the powerholder, “something that depends on the course of an entire life, rather than a single choice made in the administration of one’s wealth.”

In contrast to Kurz, a formula GPOA “OBIT” clause is not a lifetime GPOA – it’s testamentary. More importantly, unlike Kurz, it is not subject to a condition precedent, nor does the capping of the GPOA hinge at all on Treas. Reg. §20.2041-3(b) – it is pursuant to other treasury regulations cited herein. Additionally, unlike the ability of a beneficiary to withdraw at will as in Kurz, which the appellate court deemed “barely comes within the common understanding of ‘event or...contingency’”, the ability of an OBIT formula GPOA powerholder (if it would otherwise be capped) to increase their testamentary GPOA would require giving away or spending a significant portion of their assets (quite unlike Kurz) – a significant “non-tax consequence” if there ever was one. Let’s take apart the “ballooning GPOA” argument in two parts – the purported control by lifetime giving/spending/debt incurrence, and the purported control by testamentary charitable/marital bequest.

If, as some would argue, the surviving spouse’s ability to enlarge the formula testamentary GPOA by bankrupting themselves constitutes control, then arguably every beneficiary of an irrevocable trust with a means tested provision should be deemed to have a de facto general power of appointment. E.g., Jimmy, an irrevocable trust beneficiary, was used to a lifestyle spending $200,000/yr after tax. The trustee has paid him little if anything previously under “health, education, maintenance and support in the lifestyle in which he is accustomed, taking other resources available into account”. Jimmy quits his job, spends all his money on expensive gene therapy, gambling, drugs or whatever. He’s now arguably entitled to $200,000/yr from the trust, even though he could adopt a frugal lifestyle, get a job and/or subsist on 1/10 that. Under the de facto control argument, Jimmy would have a GPOA over the trust or at least over the present value of $200,000/yr if the trust is larger, but we know he doesn’t, because Jimmy’s ability to indirectly access/control the amount of appointive

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118 E.g., Treas. Reg. §20.2041-1(b)(3); “Powers over a portion of property. If a power of appointment exists as to part of an entire group of assets or only over a limited interest in property, section 2041 applies only to such part or interest” See also, Treas. Reg. §25.2518-3(d) example 20, quoted and discussed on page 20, footnotes 43, 44
assets available under the trustee’s fiduciary power of appointment is trumped by the more specific and clearer rules of IRC §2041/§2514 which clearly do not cause Jimmy to have a power of appointment in spite of his indirect control, even if Jimmy were trustee!

What of the ability of a powerholder to indirectly augment their GPOA via marital/charitable bequest? This certainly sounds like the more plausible line of attack. Again, let’s start with an example: Sandra is a widow with $7 million AEA and $7 million estate who has a formula GPOA over a $4.5 million bypass trust, left to her by her late husband (assume the cap is based on net estate after marital/charitable deductions). If Sandra gives $2 million to charity, she would otherwise have $2 million of additional basis increasing “coupon” to use over the bypass trust, if she gives $4.5 million to charity, she would in theory have control over all of it. Ditto if she marries and leaves the equivalent to her new husband. Does her ability to control the amount of the GPOA mean it is all in her estate even if she makes no charitable contribution?

Not if we properly understand the goal and theory behind IRC §2041 and estate taxation of GPOAs, espoused by Kurz and other cases. Taxation of a testamentary GPOA must look to the value of what assets it permits the powerholder to transfer to the powerholder, powerholder’s estate or creditors of either, at the time of death. Even taken together, under any scenario above, Sandra’s power to transfer to that expanded class of appointees is still limited to $7 million (AEA). Yes, she may have the limited power to control more by donating $4.5 million, but any additional control is at most an indirect LIMITED power, since any amounts above the AEA would necessarily have to go to charity and may not go to the powerholder, powerholder’s estate or creditors of either. Under no circumstance or plausible interpretation would she have the power to give $11.5 million to that class.

Other detractors of formula powers argue that various expenses and deductions that might delay the determination of the value of the appointive assets make a formula GPOA “indeterminable” and, therefore, null and void. Could Bill Gates leave a fortune to his wife Melinda in a GPOA marital trust and her estate later simply claim that the amount is “indeterminable” at the date of death because of the alternate valuation date, expenses,

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119 This is essentially paraphrasing the 7th Circuit’s Kurz opinion, at page 1029
debts, various tax election choices or any number of issues that will ultimately determine the net value of appointive assets subject to the GPOA? Good luck with that argument!

QTIP regulations specifically permit formula elections that refer to the taxable estate, even though later actions by a trustee/executor clearly affect the ultimate amount passing to the QTIP!\textsuperscript{120} OBIT formulas are similar to disclaimer and QTIP formulas in the regulations.

Despite the above analysis, many practitioners would prefer avoiding even the hint of a Kurz type argument against formula GPOA caps, and any argument that the powerholder controls the amount directly or indirectly. First, avoid calling your clause a contingent GPOA, to avoid tempting an inapt comparison of a formula clause over specific assets to the completely different concept/regulation of contingent GPOAs analyzed in the Kurz cases.\textsuperscript{121} Second, draft the formula GPOA to avoid considering any marital/charitable bequest by a power holder, even if it might in rare cases reduce the amount that might be included in a power holder’s appointive assets and potentially reduce the step up. While the formula GPOA the IRS approved in PLR 9527024 contained no such limitations or restrictions, a conservative practitioner should probably ignore any charitable/marital deduction otherwise available to the powerholder’s estate in the GPOA capping formula until there is clearer positive precedent.\textsuperscript{122} In most estate plans, this is unlikely to make much, if any, difference, so why take a chance, even if it’s remote risk?

Some may also fear some kind of public policy argument similar to the gift tax formula valuation adjustment cases and rulings.\textsuperscript{123} However, attorneys have been using valuation formulas in trusts for decades now, effecting bypass/marital, GST splits or otherwise, without any intimation that they are against public policy, not to mention that Treasury has many formula examples in its own regulations. Even aside from that, the recent gutting (or at least, 

\textsuperscript{120}Treas. Reg. §20.2056(b)-7(h) Ex 7: [After example of a “zeroed out” QTIP formula] *** “The value of the share qualifies for the marital deduction even though the executor's determinations to claim administration expenses as estate or income tax deductions and the final estate tax values will affect the size of the fractional share.”

\textsuperscript{121}E.g., see the otherwise excellent client-friendly summary of the idea in July 2014 newsletter by the law firm Day Pitney LLP at http://www.daypitney.com/news/docs/dp_5344.pdf?page=1

\textsuperscript{122}Thanks to California attorney Terence Nunan for pointing out this conservative drafting option. See his article Basis Harvesting, Probate and Property, Sept/Oct 2011, and sample language in appendix with both options

\textsuperscript{123}See, Commissioner v. Proctor, 142 F2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944), and two subsequent revenue rulings wherein the IRS will not give effect to subsequent trust changes or subsequent formula valuation changes based on IRS reassessment of valuation. Rev. Rul. 66-144 and Rev. Rul. 86-41.
mauling) of the public policy argument has been quite pro-taxpayer lately, even at the appellate level, with much more egregious facts, under McCord, Petter, Christiansen, Hendrix and Wandry.

Unlike a GPOA, the Delaware Tax Trap is only applicable to the extent of EXERCISE – there is no such thing as mere existence of an LPOA or a lapse of an LPOA causing inclusion under IRC §2041(a)(3) just because it could have been exercised to trigger §2041(a)(3). Therefore, using the Delaware Tax Trap OBIT technique is completely immune to the Kurz or “powerholder control” argument. Hence, many attorneys may prefer it, despite the advantages of formula GPOAs, for those estates that would likely be subject to capping. Pros and cons comparing the two techniques are discussed below.

Some may fear that using an LPOA to appoint to the same beneficiaries as would inherit by default might be illusory or disregarded. After all, what’s so different from appointing to trusts with PEG powers granted to children and a default that distributes to them outright? Thankfully, Treasury guidance should prevent this result.124

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124 Treas. Reg. 20.2041-1(d): “However, regardless of local law, a power of appointment is considered as exercised for purposes of section 2041 even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment.”
Comparing/Contrasting Formula GPOA v. LPOA/Delaware Tax Trap

Issues Favoring Use of Delaware Tax Trap/LPOAs over Formula Testamentary GPOAs

- **Spousal Use of Lifetime LPOAs/Gift Tax** - When someone exercises a lifetime LPOA, there is less chance of gift tax exclusion being used than if there were also a testamentary GPOA. Unless the appointment triggers the DTT, or unless income is mandated payable to the powerholder, exercising a lifetime limited power causes no taxable gift (or, at least it would probably be negligible value, as discussed elsewhere herein), whereas exercising a lifetime LPOA raises complicated issues if those assets are otherwise subject to a formula or capped testamentary GPOA – would IRC §2514 trigger a taxable gift even if the appointed assets were insurance, cash or loss property not subject to the testamentary power? Can a trustee or trust protector, if permitted, simply remove a testamentary GPOA prior to any lifetime appointment to avoid any gift argument, and subsequently add it back without ill effect?

- **Access by Powerholder’s Estate’s Creditors** – There is no asset protection issue if a powerholder’s estate is insolvent and a testamentary LPOA is exercised (or lapses) – creditors have no access. However, if the powerholder had a testamentary GPOA, depending on the state, and potentially whether the GPOA is exercised, creditors of the testamentary GPOA powerholder’s estate may have access (see discussions and citations in Part III.h.).

- **Subsequent Amendments/Releases/Non-Qualified Disclaimers/Decanting** – Generally, LPOAs can be removed or limited without gift/estate tax issue, by decanting, reformation, release, trust protector or otherwise. While there are PLRs holding otherwise, any removal or limiting of a testamentary GPOA, even with a court approval, might have gift/estate tax effects under §2514. If the beneficiary is not involved or does not consent to the removal of a GPOA, can there be a taxable gift? Arguably no, but it’s not 100% clear.

- **Easier to go beyond formula wherever/whenever inclusion may be desirable** – Because the LPOA in the document would not be limited by formula (or need not be, it may depend on the settlor’s intent), its exercise can easily cause inclusion beyond the federal and state estate tax exclusion amount if desired for specific circumstance or change in tax code. As discussed in the section on state estate taxes, there may be cases where paying state estate tax is desirable because the overall state and federal income taxes saved by beneficiaries by obtaining extra basis outweigh the state estate tax. In fact, if Congress were
to change the tax code again, this could also be true of the federal estate tax. It is already close - consider that very low basis collectibles may be taxed to a beneficiary upon sale in a high tax state (31.8% federal + up to 13.3%, not to mention PEP/Pease phase outs, AMT etc) at a rate higher than the estate tax (40% federal).

- **Actions of the powerholder/trustee irrelevant.** As discussed herein, there is an argument that trustee’s investment policy, powerholder spending or estate devise, pursuant to the *Kurz* case or otherwise, could be invoked by the IRS to override the cap and cause more assets than desired to be subject to a formula testamentary GPOA. While I think this is a weak and ultimately losing argument, the LPOA/DTT technique is completely immune to these arguments, since §2041(a)(3) is triggered only upon and to the extent of exercise.

- **The beneficiaries may have some post-mortem control over asset protection, estate taxation/basis** – A recipient/appointee might be able to disclaim a PEG power in a trust funded through the exercise of an LPOA that would otherwise trigger the Delaware tax trap and affect the upstream taxation/basis adjustment (by contrast, it is impossible for recipients to affect whether a GPOA is held at death or not). To the extent permitted, this could be important to flexibly allow increased inclusion to yield federal, state and/or local income tax benefits by additional step up, or prevent over-inclusion, or improve asset protection at the expense of a step up in basis. Disclaimers can be made partial or by formula.125

However, there are various complexities when disclaiming property received as a result of the execution of a limited power of appointment.126 A disclaimer is only “qualified” for gift/estate tax purposes pursuant to IRC §2518 if it is made within 9 months of the creation of the first power (or in the later event of nine months from a minor disclaimant turning age 21)?127 This is in contrast to receipt after the execution or even lapse of a general power,

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125 E.g. *Estate of Christiansen v. Comm.*, 586 F.3d 1061(8th Cir. 2009), there are also examples in Regulations
126 The 2014-2015 versions of this white paper missed much of this nuance, and this version corrects a few points on disclaiming PEG powers – thanks to Illinois tax attorney Robert Kolasa for bringing questions on this point to my attention. See his excellent article *Stepped-up basis for credit shelter trusts using PEG powers under Illinois law*, Illinois State Bar Association Trusts and Estates Newsletter, Vol. 62, No. 10, April 2016
127 IRC §2518(b); Treas. Reg. §25.2518-2(c)(3) “In the case of a general power of appointment, the holder of the power has a 9-month period after the transfer creating the power in which to disclaim. If a person to whom any interest in property passes by reason of the exercise, release, or lapse of a general power desires to make a qualified disclaimer, the disclaimer must be made within a 9-month period after the exercise, release, or lapse regardless of whether the exercise, release, or lapse is subject to estate or gift tax. In the case of a nongeneral power of appointment, the holder of the power, permissible appointees, or takers in default of appointment must
which grants and starts another nine month disclaimer window. There is an argument that a
triggering of the Delaware tax trap should be treated more like the exercise of a general
power for subsequent disclaimer purposes, but since the regulation cited above mentions no
exception, and also precludes a new time period for disclaimers of interests created through
exercise of limited powers in QTIPs despite estate inclusion, this argument is probably unlikely
to prevail.

Does that mean there is no chance to disclaim a PEG power absent quick successive
deaths or a minor power holder? Not necessarily – it just means the disclaimer is not
“qualified” and will constitute a taxable gift, though depending on the scheme of who takes in
default and under what terms, it may be incomplete or a gift to oneself. Because so few
people will ever fully use their lifetime gift tax exclusion, practitioners should explore when
non-qualified disclaimers may make sense, when state law will still allow a disclaimer and
what its effect will be. Most state laws are much more lenient on the time window for
acceptable disclaimers than §2518.

A non-“tax qualified” disclaimer may still “relate back”, and retroactively eliminate a
property interest such as a PEG power and it may still have beneficial asset protection effects,

Example (1). On May 13, 1978, in a transfer which constitutes a completed gift for Federal gift tax purposes, A
creates a trust in which B is given a lifetime interest in the income from the trust. B is also given a nongeneral
testamentary power of appointment over the corpus of the trust. The power of appointment may be exercised in
favor of any of the issue of A and B. If there are no surviving issue at B's death or if the power is not exercised, the
corpus is to pass to E. On May 13, 1978, A and B have two surviving children, C and D. If A, B, C or D wishes to
make a qualified disclaimer, the disclaimer must be made no later than 9 months after May 13, 1978.

Example (2). Assume the same facts as in example (1) except that B is given a general power of appointment over
the corpus of the trust. B exercises the general power of appointment in favor of C upon B's death on June 17,
1989. C may make a qualified disclaimer no later than 9 months after June 17, 1989. If B had died without
exercising the general power of appointment, E could have made a qualified disclaimer no later than 9 months
after June 17, 1989.
despite being a taxable gift for federal tax purposes. A *non-qualified* disclaimer may also remove the PEG power retroactively to affect the taxation of the exercise of the power that appointed to the trust that contains it (e.g. negate the triggering of the Delaware Tax Trap). This is in contrast to a common law release or renunciation, which probably does NOT have the same effects for state law, or the Delaware tax trap.

This can get confusing – let’s take an example and walk through the distinctions: John Doe dies and establishes an Irrev. Trust for his wife Jane. She has the limited power to appoint appreciated assets to Margaret or to Margaret in trust, such as the Jane Doe Delaware Tax Trapping Trust fbo Margaret, which grants Margaret a PEG power (presently exercisable general power of appointment, which, remember, is simply a Crummey power).

To the extent Jane appoints to this trust, and Margaret has a PEG power, it triggers IRC §2041(a)(3) – the Delaware Tax Trap. Unless Margaret disclaims within 9 months of John’s death (or unless she recently turned age 21), her disclaimer cannot be “qualified” under IRC §2518. But, what if Margaret makes a *non-qualified* disclaimer of the PEG power – one completely valid under state law, just not IRC §2518? For federal tax law, she has clearly made a gift (how much and whether it’s complete is another question). Does disclaiming the PEG power allow Margaret to eliminate any estate inclusion in Jane’s estate due to the DTT, even though it is *non-qualified*?

While there is no case law on point, whether the disclaimer is tax-qualified or not may not make a difference for the Delaware Tax Trap – we need to examine both the trust and state law, since the regulations state that “Whether a power of appointment is in fact exercised may depend upon local law”, and in contrast to GPOAs, §2041(a)(3) is only triggered by valid exercise.128 As a general rule, the disclaimer of an interest received via exercise of a power of appointment, regardless of whether it is “tax-qualified” per §2518, will relate back as if the object had predeceased the powerholder (e.g., in our above example, as if Margaret predeceased her mother Jane).129 We might then have to examine the trust and state anti-lapse statute – would the PEG power be eliminated, or simply pass to her issue per stirpes?

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128 Treas. Reg. §20.2041-1(d)
129 See discussion of these nuances in the Uniform Disclaimer of Property Interests, § 10, example 1 and 2(b) and Uniform Probate Code §2-1110 based thereon.
The easy answer to this is for Jane to simply draft the exercise/DTT trust clearly to preclude such application (“to the extent that my daughter Margaret disclaims her presently exercisable general power of appointment granted above, regardless of whether the disclaimer is qualified under federal gift tax law, provided it is valid under state law, such power shall be completely extinguished, despite any state anti-lapse statute to the contrary, as if the power had never existed”).

Let’s briefly contrast a common law release or renunciation, which is similar to a non-qualified disclaimer, but has important differences for asset protection and the Delaware tax trap. If Margaret accepts some of her power, or takes any action that under state law would prohibit a state law disclaimer, she might still always release or renounce her power. The effect is nearly identical prospectively, but the important difference between these two legal concepts is that releases are not retroactive, whereas disclaimers are; releases may be fraudulent transfers; disclaimers usually aren’t. The regulation is clear that a renunciation by an appointee does not negate the exercise by the power holder.

Is the trust still a non-self-settled trust pursuant to state law after a PEG power is disclaimed? Probably yes. One or two states may allow a creditor to void a disclaimer if the disclaimant is insolvent, and there may be additional questions in bankruptcy or tax liens, but in general such disclaimers, even if not tax-qualified, can be effectively planning tools to allow the subsequent trust to remain protected from creditors.

- **You can give your most trusted beneficiaries a de facto veto power, allowing more family control and more post-mortem flexibility than a GPOA.** For example, if I establish a trust for my wife, remainder to my daughters, I might want my daughters to have a veto power – to require their consent for any appointment by my wife – who knows what undue

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130 These distinctions and effects may vary state to state. See NY EPTL § 2-1.11, which deems a “renunciation” under that statute to be retroactive. The terminology is not as important as the legal effect – is it a transfer by the power holder under state law or not? The Uniform Disclaimers of Property Interests Act § 13(f), Uniform Probate Code as § 2-113(f), provides: "A disclaimer of an interest in property which is barred by this section takes effect as a transfer of the interest disclaimed to the persons who would have taken the interest under this [Act] had the disclaimer not been barred."

131 Treas. Reg. §20.2041-1(d): “***However, regardless of local law, a power of appointment is considered as exercised for purposes of section 2041 even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment."
influence she might encounter without me! Remember that estate inclusion via GPOA is **not** triggered under §2041(a)(2) and §2041(b) if I require *adverse party* consent. Perhaps I don’t have a trustworthy person to be a “non-adverse party”, or I fear creditors or others might browbeat the “non-adverse party” - they would have absolutely no fiduciary duty whatsoever to my daughters (and they, in turn, no recourse). But §2041(a)(3) does not rely on a definition of a general power of appointment – it pertains to the *exercise* of a *limited* power. If my daughters determine that for asset protection or other reasons they don’t want to allow my wife’s appointment, or they would like to limit the appointment to certain assets, they can have a veto power over an LPOA, and the adverse consent requirement would not impair inclusion.

This even allows my daughter to pick and choose the assets to receive the new basis (the power should be clear that the consenting party can consent or not as to each particular asset), giving additional flexibility and back up protection. For example, if my daughter and her husband had tax issues but they did not tell her mother (not uncommon in families) it would be ideal to forego the step up in basis afforded by appointing to a trust with a PEG power for the better creditor protection of an ongoing discretionary trust without one. While a powerholder might be able to make a non-qualified disclaimer of PEG powers, a few states (*and IRS liens*), do not follow the relation back doctrine as to creditor protection, so required consent may be superior.\(^{132}\)

- **An LPOA/DTT can be used by a QTIP as well.** Why would someone want to trigger §2041(a)(3) when QTIP assets are going to be included under §2044 anyway? **Aggregation.** As discussed in Part II.d., if a spouse has 50% of an LLC worth $1 million and 50% owned in QTIP, the beneficiaries will get “discounted” adjustments to basis, shaving off hundreds of thousands of dollars of valuable basis – but inclusion under §2041 should lead to aggregation, **overriding** the QTIP’s segregation of assets from the rest of the estate for valuation purposes. It also grants the objects of the appointment or takers in default an additional 9 month window to disclaim, as discussed in Part IV below.

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\(^{132}\) See the *Drye* case, restatement, cases and statutes cited in footnote 24, notable exceptions to disclaimer protection include Medicaid look back, federal tax liens
Issues Favoring Use of Formula Testamentary GPOAs over Using LPOAs/DTT

- **Doesn't rely on obscure/arcane rule against perpetuities nuances.** Experts seem to agree that appointing to a trust that grants someone a presently exercisable GPOA triggers §2041(a)(3) because the GPOA powerholder can postpone vesting/suspend alienation without regard to the original RAP period. How confident are you that your state law (or trust!) does not have a savings clause or construction that prevents triggering §2041(a)(3)? How does this interpretation further Congressional intent of thwarting continued transfer tax avoidance if the GPOA causes gift/estate tax in the PEG powerholder’s estate? (Very little, unless you consider the gradual escape via 5/5 lapse protection of §2514(e)). While this technique appears to work (the regulations imply so as well), there is no reported case confirming this. The only reported case on this issue found that §2041(a)(3) was not triggered. As discussed above, the ability to simply incorporate other states’ more favorable laws to allow more protective Delaware Tax Trapping trusts without reliance on PEG powers is also uncertain.

- **Less documentation/probate/paperwork, less chance of something falling through the cracks.** A formula GPOA doesn’t even have to be exercised to get the intended benefit, but the LPOA/DTT technique requires an additional exercising document (usually by will), potentially a probate filing if by will (though it does not mean a full probate need be opened or that appointive assets are probate assets). Plus, invoking the DTT usually means a new separate “DTT-trapping” trust to appoint to (even if it’s only one page, or referring to another subtrust with a few sentences added).

- **Better ongoing asset protection for beneficiaries** – although the GPOA might be more prone to access by a decedent powerholder’s estate (discussed above), it is much more likely that one of the children has creditor issues than a bypass trust spouse/beneficiary. Even aside from outside creditors, granting a child a PEG power may jeopardize the assets (or even more likely, the growth on those assets), in a divorce, or subject the assets to a spousal elective share.\(^\text{133}\) Query how a PEG power over only the remainder interest would be viewed. This

\(^{133}\) This is contrary to a testamentary power, as discussed in Part III.h. – see citations in that section.
assumes a PEG power must be used and one cannot use DE/AZ law to trigger the DTT without granting a PEG power.

- **No waste of GST exclusion, assets can excluded from beneficiaries’ estates** – when a child or other beneficiary inherits in trust pursuant to a formula GPOA, GST will be allocated, and if properly drafted the subsequent trust escapes taxation in the beneficiaries’ estate for federal and state estate tax. By contrast, this is near impossible to do if the beneficiary receives assets with an attendant PEG Power (w/ possible exception for annual 5/5 lapses).

- **Children or other beneficiaries can spray income** – When a beneficiary receives trust assets with a typical PEG Power, there is a forced grantor trust (beneficiary-deemed owner) status under IRC §678(a). If the PEG power is limited to the remainder interest, then there would be a partial forced grantor trust status as to principal. Whereas, if a beneficiary inherits in a standard trust, he/she can avail themselves of opportunities to avoid state income tax, shift income and obtain more favorable above the line charitable tax deduction opportunities (beneficiary-deemed owner v. non-grantor trust status is discussed in Part VII) – in short, using a typical GPOA gives more flexibility to have non-grantor or beneficiary-deemed grantor trust status in the appointive trust, rather than be forced into the latter.

- **Next generation use of lifetime LPOAs/gift tax** – If a beneficiary receives trust assets with a PEG power, any subsequent use of lifetime POAs will trigger a gift tax and may in some cases be an assignment of income. By contrast, if a beneficiary receives assets in trust without a PEG power, lifetime LPOAs and spray provisions may be used for better income tax planning with little or no gift tax burden.

- **No potential issue re triggering DTT if powerholder moves state** – If a surviving spouse or other beneficiary moves to another state or the trust changes situs/choice of law, will this affect the powerholder’s ability to trigger the DTT? Perhaps not, but it raises another potential tricky issue that formula GPOAs do not have – since those trigger estate taxation largely regardless of state law quirks.

- **For intervivos SLATs, can revert to Settlor w/o impairing protection** – If the trust is question is a SLAT (aka inter-vivos bypass trust), and the donee spouse appoints back in trust to the original settlor/donor spouse, is the new trust considered “self-settled” subject to the
original settlor’s (now beneficiary’s) creditors? If the spouse executed a GPOA, she would clearly be considered the new grantor/settlor for state law as well as tax law, but if the spouse merely executed an LPOA, this would “relate back” and therefore under most state laws the original settlor would remain and still be considered the settlor and the trust would be accessible to the settlor-beneficiary’s creditors. This favors the use of formula GPOAs for SLATs and JESTs (see part V).

**NOTE:** in the above section and comparison I have largely assumed use of only the most commonly discussed/accepted method of triggering §2041(a)(3), which involves the powerholder appointing to a new trust which grants a PEG power. If, in your state, there is a reliable way to trigger §2041(a)(3) without this generally undesirable feature (e.g. by appointing to a new trust that can postpone vesting/ownership and need not refer to the RAP applicable to the first trust and does NOT have a PEG power), then this may well tip the scales towards using a limited power triggering §2041(a)(3) over a formula GPOA.

State law has inadvertently become extremely elitist in this regard, with RAP savings statutes that hurt 99.5% of the population and help less than 1%. According to the ACTEC survey, Kentucky and Wisconsin will apparently allow §2041(a)(3) to be triggered by appointment to a new trust with a testamentary GPOA. Until very recently, Delaware did not allow much more leeway either, because it barred the triggering if the trust was GST exempt (zero inclusion ratio), the very situation that 99.8% of the population will now want to use it for! However, Delaware just recently amended their statute to allow an opt-in as this white paper has advocated.\(^{134}\) State bar committees/legislatures should consider amending their RAP statutes to allow a specific reference in the instrument to “open the trap”, with an affirmative and specifically referenced “opt-in”, similar to Arizona and Delaware. Texas, Florida and Colorado bar committees have begun to draft proposed legislation for their

\(^{134}\) 5 Del. Code Title 25, § 504, amended by 79 Del. Laws, c. 352 (effective August 1, 2014)
bar/legislature to consider. More will certainly follow. In the Appendix is a proposed variant of Delaware’s law, modified for use in Ohio.

A more interesting question is whether we can simply incorporate one of these state’s laws into our trust for this purpose, without the need to hire a trustee in that state or have other nexus. As a general rule, common law and the Uniform Trust Code allow a settlor to choose which state law applies (or, potentially for a trustee, trust protector or court to change it):

“SECTION 107. GOVERNING LAW. The meaning and effect of the terms of a trust are determined by: (1) the law of the jurisdiction designated in the terms unless the designation of that jurisdiction’s law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue; or (2) in the absence of a controlling designation in the terms of the trust, the law of the jurisdiction having the most significant relationship to the matter at issue.”

Scenario: your client is on their deathbed. They are a beneficiary of a trust with highly appreciated assets in it, they have a limited testamentary power of appointment and plenty of spare applicable exclusion amount such that triggering inclusion of the appreciated trust assets in their estate would have no detrimental federal or state tax effect. The trust allows a change of situs/law or state law would otherwise allow a non-judicial settlement agreement to effect the same. Can you simply change the applicable law to Delaware or Arizona and have your client opt in to the Delaware Tax Trap by appointing to a trust that triggers the Delaware tax trap with a mere limited power of appointment in the appointive trust, without the need for the brute force and negative consequences of adding a PEG power? Would DE or AZ law, which permits the holder of the limited power to start a new rule against perpetuities period without referencing the original trust date, be “contrary to a strong public policy” of your state?

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135 ARS §14-2905(C). Thanks to attorneys Mickey Davis (TX), Justin Savioli (FL) and John Debruyn (CO) for sharing their respective state proposals modifying Tx Stat. Sec. 181.083, Fla Stat. 689.225, Co. Stat. § 15-11-1102.5. Other state bar committees should strongly consider reviewing these to adapt their own version.

136 25 Del. Code §504

137 Uniform Trust Code §107, see also Restatement, Second, Conflicts of Laws §270

**Probably not.** This is a far cry from spousal elective shares, charging orders and validity of self-settled trusts, where states (and creditors!) have extremely strong interests against application of other states’ debtor-friendly or unprotective laws to assets and residents in their jurisdiction.139 The one exception might be states that have a state constitutional prohibition on perpetuities of some sort.140 However, in the majority of states, there should be no issue. The general rule is that the rule against perpetuities is simply not a “strong public policy” that would warrant an exception to the general rule stated in Section 107 of the UTC quoted above.141

However, there is probably not much to lose should you simply draft the appointment in the alternative: “It is my intention that my appointment to the XYZ Delaware Tax Trapping Trust, coupled with this trust’s choice of law, trigger §2041(a)(3). Should my trust’s choice of law in this regard be void, such appointment shall be ineffective, and I hereby appoint in trust under identical terms to the XYZ Delaware Tax Trapping Trust with the following additional paragraph...[insert PEG power]”.

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139 E.g., In re Huber, 2013 Bankr. LEXIS 2038 (May 13, 2013)
141 Restatement, Second, Conflict of Laws, §269, comment i: i. Policy of state of testator's domicil at death. A trust provision in a will is invalid to the extent that it is invalid under the strong public policy of the state of the testator’s domicil at death, even though it would be valid under the local law of the state designated in the will to govern the validity of the trust or under the local law of the state where the trust is to be administered. The mere fact, however, that the provision would be invalid under the local law of the state of the testator’s domicil does not invalidate the provision. If the provision is valid under the local law of the state designated by the testator or under the local law of the place of administration, it will be held to be valid if it does not contravene a strong policy of the state of the testator's domicil. No such strong policy is involved in rules against perpetuities or rules against accumulations or rules as to indefiniteness of beneficiaries. On the other hand, when a testator who dies domiciled in one state leaves his estate to a trust company in another state in trust to pay the principal to a beneficiary if and when the marriage to the beneficiary's present wife should be dissolved, and the condition is against the strong public policy of the testator's domicil as tending to encourage divorce, it may be held that the condition is illegal, even though it would not be illegal under the local law of the state of administration. Possibly in such a case it would be held that the local law of the beneficiary's domicil would be applicable.
IV. Busting Disclaimer Myths and the Conventional Wisdom on Disclaimers: Why OBITs are Superior to Bypass Trusts for Disclaimer Based Planning

After Congress’ awkward dance with estate tax repeal over the last decade, many practitioners and clients have embraced disclaimer planning as the go-to tool for married couples with identical estate plans (e.g. long-time marriage, all children from current marriage). This usually involves setting up a bypass trust (and potentially marital trust, depending on design, assets and circumstance) that is ONLY funded if the surviving spouse makes a qualified disclaimer of funds that would otherwise be inherited outright.

There are several drawbacks to relying on disclaimer funding – inadvertent disqualification through acceptance or control, limited nine month window (no extensions unless the spouse is under age 21), uncertainty with certain jointly owned assets, and quite simply, the powerful inertia causing a widow/widower to “go with the flow” – especially when the flow is an outright bequest. For purposes of this Section, however, I will concentrate on another important drawback of disclaimer planning and how the OBIT largely eliminates it.

a. What Types of Powers of Appointment Spouses Can Retain Post-Disclaimer

One of the axioms estate planners are continually taught is that surviving spouses must disclaim a power of appointment granted in a trust they are disclaiming into. Such a disclaimer removes a tremendous estate, asset protection and income tax planning tool from the surviving spouse’s toolbox. Moreover, this general rule is wrong. The disclaimer regulations for surviving spouses are much more nuanced than that.142

“If the surviving spouse, however, retains the right to direct the beneficial enjoyment of a property in a transfer that is not subject to Federal estate and gift tax (whether as trustee or otherwise), such spouse will be treated as directing the beneficial enjoyment of the disclaimed property unless such power is limited by an ascertainable standard.”

Thus, if the spouse is trustee and retains a discretionary spray power not limited by an ascertainable standard, or the right to transfer property by power of appointment that does not trigger estate/gift tax, then the disclaimer would not be qualified. However, this still leaves tremendous opportunities for various OBIT powers as discussed in Part III above.

142 Treas. Reg. 25.2518-2(e)(2)
Thus, a GPOA can be retained by a spouse without tainting a qualified disclaimer, because GPOA transfers are of course subject to federal gift and estate tax under IRC §2514 or IRC §2041 respectively. As discussed in Part III, this would ideally be a formula testamentary GPOA with a cap. There is no advantage to retaining a lifetime GPOA (and a rather severe asset protection disadvantage). Moreover, an LPOA may also be retained, but only if can only be exercised so as to trigger the Delaware tax trap (IRC §2041(a)(3) and/or IRC §2514(e)), or is limited by an ascertainable standard. More creatively, targeted collateral LPOAs held by other friendly parties, such as a sibling, could also be included and retained, without this constraint.
b. **Keeping Testamentary POAs in QTIPs Post-Disclaimer**

Surprising to many, a testamentary LPOA may be retained in a QTIP, since it would be in the surviving spouse’s estate via IRC §2044 (QTIP).\footnote{There is authority that an LPOA may be retained by a surviving spouse to the extent the QTIP election is made: *Estate of Lassiter v. Commissioner*, T.C. Memo 2000-324, p70-74, ruled a disclaimer was qualified despite the surviving spouse retaining a testamentary LPOA, because the later transfer at the surviving spouse’s death would be subject to federal estate tax due to the QTIP election, an exception under Treas. Reg. §25.2518-2(e)(2) quoted above. “We therefore conclude that retention of such a testamentary power does not cause the disclaimer of an inter vivos power to fail to satisfy the section 2518 requirement when a QTIP deduction will be taken for the trust to which the powers relate.” A lifetime LPOA should equally be permitted due to IRC §2519 causing a taxable gift over the entire amount of the transfer, if not the entire trust. A bypass trust, however, can be more targeted.} The *Lassiter* holding regarding QTIP trusts surprises many practitioners – it’s rarely discussed in articles, treatises or CLEs, yet it is not a mere PLR so holding, it’s a tax court case. Be careful, however, to elect QTIP before disclaiming into the trust, rather than after, even if an additional six months may be permitted (important for Clayton QTIPs), or be clear that any ordinary LPOA is also disclaimed from any Bypass or subtrust over which QTIP is not elected.

So, while it is true that a disclaiming spouse must disclaim ordinary LPOAs in a bypass trust if funded via disclaimer, a disclaiming spouse may retain narrowly crafted ones.\footnote{Treas. Reg. §25.2518-2(e)(5) Ex. 5 illustrates why disclaiming spouses may not retain ordinary LPOAs in a bypass trust in order to be qualified, but Ex. 7 illustrates that disclaiming spouses may retain GPOAs (the “5 and 5” withdrawal power in the example is a lifetime GPOA, aka PEG power, “subject to Federal estate and gift tax”)} Appropriately worded “OBIT” LPOAs and GPOAs are therefore still compatible with and complementary to disclaimer planning. Practitioners should consider creative post-mortem planning opportunities in this area – powers might be partially released rather than completely disclaimed, for example (see sample clauses). Most states should allow a partial release/nonqualified disclaimer of a testamentary LPOA unless the document forbids it.\footnote{See, e.g., the Uniform Powers of Appointment Act, §401 and §404, at [www.uniformlaws.org](http://www.uniformlaws.org), but see Mich. Comp. Laws §556.118(2) for a counterexample.}

Retention of LPOAs or formula GPOAs not only permit much better basis increase (and avoiding basis decrease) at the spouse’s death, but they also open up more flexible *ongoing income tax* planning opportunities discussed in Part VIII of this paper.

Moreover, even trusts that are not initially planned to be “disclaimer” trusts, may someday be forced to be, since clients inevitably fail to keep their trust fully funded. So these techniques should be kept in mind – disclaimer funding does not mean giving up all POA flexibility whatsoever – it just requires tailoring it.
c. How OBITs open up better post-mortem disclaimer planning at 2nd death

Not only do OBITs enable better and more flexible estate planning at the first death, they permit more flexible estate planning at the surviving spouse’s death. As discussed in Part III, the general rule for qualified disclaimers is that an appointee attaining property from the exercise of a limited power of appointment, even if the assets are in the decedent’s estate as a QTIP trust, must disclaim within nine months of the date of the original creation of the limited power (i.e. the date of gift for inter vivos irrevocable trusts, or the date of the settlor’s death for those funded post-mortem). By contrast, an appointee or beneficiary who is taker in default of a general power is afforded an additional 9 month window after the death of the holder of the testamentary general power of appointment.

Let’s contrast with a brief example. Husband establishes QTIP trust or ordinary bypass trust for wife, then children. More than 9 months pass, then spouse dies. Whether she exercises a limited testamentary power of appointment or not, it is too late for the children to disclaim under §2518. If they have a taxable estate, creditor problems, pending divorce, state tax liens, would like to shift IRD income to the next generation in a lower tax bracket or to charity or any other circumstance where a qualified disclaimer might be warranted, they are out of luck – at least, there is no chance the disclaimer will be tax-qualified – as discussed in Part III it may still qualify for some aspects under state law.

By contrast, if the trust were an OBIT trust, to the extent a formula GPOA is triggered, whether it is exercised or not, §2518 would permit the beneficiaries (whether they are appointees or takers in default) an additional nine month window from when the surviving spouse dies, without causing any ill gift/estate/gst tax effects.

So, would you prefer a trust design that enables the next generation to do disclaimer planning at the surviving spouse’s death, or forbids it?

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146 Treas. Reg. §25.2518-2(c)(3), which is extensively cited with examples in footnote 123 above.
V. Optimizing Basis Increase at First Death or Other Deaths via Upstream Planning

a. Community Property Nuances – Transmutation Agreements and IRC §1014(b)(6)

Married couples living in community property states automatically receive a new date of death basis for 100% of community property (which can, of course, mean a step down in basis for 100% of such property as well). Some property, however, perhaps nearly all, might be separate even for those in community property states – such as property received by gift/bequest, or assets acquired prior to marriage. Increasing step up in basis at first death for such separate property (and avoiding double step downs for community property that has decreased in value) may be accomplished through postnuptial transmutation agreements and those valid under state law are also binding on the government for federal tax purposes.

Example #1 (community property state): John and Jane are on their second marriage late in life and therefore have significant separate property. Residents of a community property state, John and Jane might enter into an agreement that $1 million each of their low basis property is now community property. Of course, if John’s former separate property value skyrockets to $2 million, and Jane’s stays the same at $1 million, and they are later divorced, this $3 million is 50/50 for divorce purposes, probably divided into two $1.5 million shares rather than $2/$1 million split had they not transmuted the property. But many clients could live with this, when considering that if one dies, all $3 million gets a new adjusted basis – a substantial windfall for the widow/widower - and potentially other beneficiaries.

If a couple moves from a community property state to a non-community property state, assets acquired as community property may retain that status.

Transmuting property to community status is not without drawbacks – not only would transfers decrease testamentary control and impact divisions in a divorce, but depending on the state, there may be restrictions on gifting or greater exposure to creditors.

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147 IRC §1014(b)(6). States and territories with a default community property system are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, Wisconsin and Puerto Rico
148 U.S. v. Elam, 112 F.3d 1036 (9th Cir. 1997)
149 Sixteen states have adopted the Uniform Disposition of Community Property Rights at Death Act as of 2014 (at www.uniformlaws.org), which provides that on the death of a spouse, the community property rights of the estate and survivor will be respected: AK, AR, CO, CT, FL, HI, KY, MI, MN, MT, NY, NC, OR, UT, VA, WY. Other states may honor it under case law: see Restatement, Conflict of Laws, §259, comment b
b. **AK/TN Community Property Trusts - Can Residents of Non-CP States Elect CP?**

For married couples in separate property states, jointly owned property is usually only entitled to 50% step up (or down).\(^{151}\) Those living in separate property states may be able to accomplish the same result as community property state residents through the use of an Alaska or Tennessee Community Property Trust, keeping “loss” and/or qualified plan or other problematic property out of the trust and transferring only appreciated gain property to the trust to elect into a community property regime.

Example #2 (separate property state): Same as above, but John and Jane have *never* lived in a community property state and don’t plan to. They gift those assets into an Alaska or Tennessee Community Property Trust, in which they **elect** to treat the property as community property. This should in theory give the same result as above.

The code section that permits the surviving spouse’s portion to be stepped up only applies to “***property which represents the surviving spouse’s one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State***”. Would it still be held by “the decedent and the surviving spouse” if titled in trust with an outside trustee? Yes, at least for revocable living trusts.\(^{152}\)

While there is a compelling argument that Alaska or Tennessee Community Property Trusts should work equally well, to date this technique has not been tested in the courts or subject to any IRS ruling, even though Alaska’s Community Property Act has been around since 1998.\(^{153}\) The only IRS pronouncement recognizes a potential difference for an elective regime, and excepts such a regime from its guidance.\(^{154}\) Wisconsin’s statute that defaults to community property but allows a married couple to opt out received a favorable IRS revenue ruling.\(^{155}\) There is no such ruling for elective community property trusts, however.

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\(^{150}\) E.g. **all** community property may be susceptible to creditors of only **one** spouse! Tex. Fam. Code §3.202(d)

\(^{151}\) IRC §2040(b) will limit estate inclusion of “qualified joint interests” such as joint tenancy or tenancy by the entireties to 50% (tenancy in common or more than three owner joint tenancies would be under a different general rule under IRC §2040(a). Community property that also has a right of survivorship would still receive the generally more favorable basis treatment. See Rev. Rul. 87-98. While rarer every day, you have a different rule if you run across joint property purchased pre-1977 per *Gallenstein v. U.S.*, 975 F.2d 286 (6th Cir. 1992).

\(^{152}\) Rev. Rul. 66-283

\(^{153}\) Alaska Stat. §34.77.100 et seq. with the community property trust requirements at §34.77.100

\(^{154}\) IRS Publication #555 “Community Property”, page 2: “**Note.** This publication does not address the federal tax treatment of income or property subject to the “community property” election under Alaska state laws.”

\(^{155}\) Rev. Rul. 87-13
Moreover, there is a negative Supreme Court case from 1943 that denied the income tax advantages of an earlier Oklahoma elective community property regime for income tax splitting.\textsuperscript{156} Conclusions vary on whether \textit{Harmon} would today control for elective community property trusts’ effectiveness for IRC §1014(b)(6), but it’s close enough to be uncertain.\textsuperscript{157}

Conflict of law principles should permit spouses to choose a state other than their domicile to govern their respective interests in property, and that state’s laws should apply unless the domiciliary state has a strong interest or public policy in applying its own laws instead.\textsuperscript{158} Using an Alaska trustee to hold legal title and provide various trustee services (even if they may be limited to investment or custodial services), should strengthen the argument that it is appropriate to apply Alaska law. That said, most proponents of domestic asset protection trusts did not anticipate the \textit{Huber} decision either, which held that the state of Washington’s public policy against self-settled trusts trumped a choice of Alaska law.\textsuperscript{159}

Many couples may not be interested in a solution that requires Alaska or Tennessee trustee services with attendant fees and complexity, and the use of additional counsel to execute or amend the trust. Furthermore, this would not appeal to a spouse who has much more separate property than the other, because of the obvious divorce ramifications. There may be significant non-tax drawbacks to the arrangement, aside from the uncertainty of the tax result and the continued viability of the \textit{Harmon} decision.

Additionally, there is at least one state in the union that has a prohibition on post-nuptial agreements (ergo, a “strong public policy” against them) – Ohio.\textsuperscript{160} Ohio’s statute may well prohibit its residents from using this technique, because such transfers would “alter their legal relations”.

\begin{footnotesize}
\begin{enumerate}
\item[156] \textit{Commissioner v. Harmon}, 323 US 44 (1944): “The important fact is that the community system of Oklahoma is not a system, dictated by State policy, as an incident of matrimony.” This certainly applies to TN/AK CP trusts.
\item[158] See Restatement, Second, of Conflicts of Laws, §258, comment b, and §270 (regarding trusts). See also Uniform Probate Code §2-703
\item[159] \textit{In re Huber}, 2013 Bankr. LEXIS 2038 (May 13, 2013)
\item[160] Ohio R.C. §3103.06 “Contracts affecting marriage. A husband and wife cannot, by any contract with each other, alter their legal relations, except that they may agree to an immediate separation and make provisions for the support of either of them and their children during the separation.”
\end{enumerate}
\end{footnotesize}
c. The overlooked fractional interest dilemma of community property

Discussion with attorneys about community property often ends with the conclusion that for income tax purposes, community property is clearly superior for married couples. But is it always? Let’s explore a few examples that may be reminiscent of the Nowell, Lopes and Mellinger cases discussed in Part II.d. above:

- John owns 100% real estate as separate property. He dies. Basis is full FMV as of date of death.
- John owns same as community property. He dies. Basis is discounted as if two 50% TIC interests.
- John owns 100% LLC, separate property. He dies. Basis is undiscounted FMV as of date of death.
- John owns same LLC, but as community property. He dies. 50% share valued w/discount: perhaps 15-30%?
- Same as above, but John only owns 80% of LLC and dies. His 40% is discounted even further: perhaps 20-45%?

The rule that most practitioners think of whereby you simply take the full value of a property and divide by two for estate tax (and therefore basis) purposes requires a right of survivorship:

(b) Certain joint interests of husband and wife
(1) Interests of spouse excluded from gross estate
Notwithstanding subsection (a), in the case of any qualified joint interest, the value included in the gross estate with respect to such interest by reason of this section is one-half of the value of such qualified joint interest.

(2) Qualified joint interest defined. For purposes of paragraph (1), the term “qualified joint interest” means any interest in property held by the decedent and the decedent’s spouse as—
   (A) tenants by the entirety, or
   (B) joint tenants with right of survivorship, but only if the decedent and the spouse of the decedent are the only joint tenants.161

161 IRC §2040
This discounting of community property surprises people (it is contrary to guidance in IRS Publication 555 on page 8, but that is not “authority”), but there is clear controlling authority in the two main circuits that deal the most with community property, and in the tax court, and the above examples are simply drawn from those cases:

In Propstra, a decedent’s one half share of naked real estate held as Arizona community property was held to be required to be valued at a 15% discount.162

In Lee, a decedent’s share of 80% of a closely held corporation held as community property was held to be required to be valued as a non-controlling 40% minority interest, and her share of 100% owned as community property was required to be valued as a 50% share, and discounted accordingly.163

In Bright, a 55% share owned as Texas community property was required to be valued for estate tax/step up purposes as two 27 ½% interests.164 These cases are all discussed in Rev. Rul. 93-12, albeit in the context of gift tax valuation rather than estate tax, but the central lesson is that the advantage of community property step ups is severely muted, and can easily lead to step downs in basis, when dealing in real estate or closely held entities, if not careful. Imagine your client invests $1 million in a 90% share of an LLC held as community property, only to find out the basis is REDUCED by 30-40% when their spouse dies shortly thereafter.

Many community property states do allow community property with right of survivorship.165 But as a general rule this form is disfavored and may require specific written or even recorded agreements to be effective, and even a property that states it is joint with right of survivorship may not be.

162 Propstra v. United States, 680 F.2d 1248 (9th Cir. Ariz. 1982)
164 Estate of Bright v. United States, 658 F.2d 999 (5th Cir. Tex. 1981)
d. **Attaining Additional Basis at First Death – Integrating Optimal Basis Techniques (Including Joint GPOA or “Joint Exemption Step Up Trusts” – aka JESTs)**

The so-called “joint GPOA” (f.k.a. poorer spouse funding technique) trust proposed by some to use in separate property states could be a more viable solution. However, it could also be a disaster, because IRC §1014(e) may require a step down, but deny a step up.\(^\text{166}\) Moreover, it may use up twice the gift/estate tax exclusion for no good reason. With these caveats, it should still be considered. This section will discuss ways to avoid these results and tweak for optimal basis increase results, and ensure the best chance for obtaining step ups in basis for both spouse’s assets at first death, even in a non-community property state.

First, how does this structure typically work in the PLRs and articles discussing them? Let’s say H has $2 million of property and W has $2 million.\(^\text{167}\) Copying PLR 2006-04028, H puts his $2 million into his revocable living trust, W puts her $2 million into her revocable living trust.\(^\text{168}\) Each trust grants the non-grantor spouse a GPOA up to their remaining applicable exclusion amount (some GPOAs in the PLRs are presently exercisable, some testamentary). Thus, if H dies, H can not only control disposition of his $2 million, but W’s $2 million in trust as well (and vice versa). Mimicking the PLR, H amends his Will to appoint W’s trust assets to his own trust at his death. Should H die, all $4 million goes into his trust.

What everyone agrees on, including the IRS: at H’s death, W’s $2 million trust is included in H’s estate because of the GPOA. W is deemed to have made a taxable gift by allowing H to appoint her $2 million to H’s trust for her. What everyone does not agree on: how the gift of the $2 million in W’s trust transferred via H’s GPOA is treated (does it qualify for the marital deduction? If not, is it partially a gift to oneself?) and whether an adjustment in basis is denied. In addition to these two main issues, there are also potential issues with the step transaction doctrine, reciprocal trusts and state law creditor protection issues.

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\(^{166}\) See PLRs 2001-01021, 2002-10051, 2004-03094, 2006-04028, TAM 9308002. Many question the holdings that transfers from the owner-spouse to the decedent-spouse at death qualify for the marital deduction under IRC §2523. However, other aspects of those rulings are non-controversial, including capping a GPOA to an amount able to be soaked up by a power holder’s applicable exclusion amount. Regardless, those with smaller estates probably would not care about the marital deduction and “double use” of exclusion anyway.

\(^{167}\) Thus, this is no longer really a “poorer spouse” technique, the “poorer spouse” problem has largely been eliminated by portability except for GST exploitation and common disaster scenarios – see Part I of this article.

\(^{168}\) Other PLRs use joint trusts, but my preference, and the preference of most attorneys in non-CP states, would be to use two separate trusts for better tracing and administration, but the same concepts apply to joint trusts.
e. **Marital Deduction under §2523 for Gifts to Spouse Complete at Death**

All of the PLRs and TAM accept the premise that the $2 million gift qualifies for the marital deduction, even though the donee spouse would arguably be dead – the GPOA becomes effective, and the relinquishment of control by W to complete the gift, at death. Those rulings were quite favorable to taxpayers - arguably IRC §2523 would not allow the deduction.\(^{169}\)

However, the marital deduction is now completely moot for many clients, whose combined estates may be under one spouse’s applicable exclusion amount, especially when augmented by portability. In our example above, using 2013 values, denying the §2523 deduction would cause W to have $3.25 million basic exclusion amount instead of $5.25 million (due to $2 million gift not qualifying for the marital deduction). Her DSUE from H’s estate would be either $5.25 million (if H’s own $2million and GPOA appointment went to his wife or a marital deduction trust), or $1.25 million (if none of H’s $4 million qualified for marital deduction), or in between for other dispositions, partial QTIP elections, etc. This still gives her between $4.5 million and $8.5 million AEA – either way, she is nowhere near having a federal estate tax issue by the loss of $2 million gift/estate tax exclusion (if it is that much, see below)! Even this effect can be mitigated with techniques discussed below.

The smart play by W may be (if the value merits) to at least try to claim the deduction on her Form 709 gift tax return and attach all relevant information – at least there is a colorable argument and several PLRs. After all, as discussed in Parts I and II, treasury regulations accept the fiction of surviving spouses in qualifying for the marital estate tax deduction in simultaneous death scenarios, and there are cases that suggest the gift at the moment of death is to a surviving spouse.\(^{170}\)

Furthermore, if IRC §2523 does not apply, who is the gift to if not to the spouse, and how much is taxable? This is never addressed in articles on this subject, but it may be quite

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\(^{169}\) Learned attorney opinions of the IRS’s conclusions range from scathingly dismissive - “smoke and mirrors” to accepting - “common sense suggests that the IRS is correct on the marital deduction issue”, from Clary Redd’s article *Sharing Exemptions? Not So Fast*, Trusts and Estates, April 2008 and *It’s Just a JEST, the Joint Exempt Step-Up Trust*, LISI Estate Planning Newsletter #2086 (April 3, 2013) by Alan Gassman, Thomas Ellwanger & Kacie Hohnadel, respectively. The issues are much more complex than you would think for a simple technique.

important. If you cannot gift to a corpse (here, W gifting to her dead H), then the gift must be to H’s estate or appointees, who are – you guessed it – W and children! If W makes a $2 million gift to a corporation or LLC in which she is 40% owner, the IRS looks through to the company owners as donees - it is not a gift of $2 million, it is a gift of 60% of $2 million - $1.2 million.\footnote{Treas. Reg. §25.2511-1(h)(1), see also PLR 9114023} If a spouse or charity owns portions of the 60% it may be deductible for gift tax.\footnote{Of course, these deductions are based on what the donee receives, which, depending on the valuation of the business before and after, may not increase by the full $1.2 million – it may increase by less.} If you gift to a probate estate, the gift is really to the beneficiaries of that estate. If W inherits 100% of H’s estate, then the gift is to herself, and not taxable. But, presumably, H’s estate would pour into a trust in which W has a lifetime interest plus HEMS. If her share might be valued at 40%, shouldn’t the result be similar to the corporation donee example? This is easy to value with a simple net income or unitrust, but if there are spray provisions, LPOAs, etc, keep in mind that “if the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift.”\footnote{Treas. Reg. §25.2511-1(e)}

More confusingly, I mentioned above that the true donees would logically be “H’s estate OR appointees” – what if those are not the same? Arguably, W’s gift would be to H’s estate, not the appointees, because it was H’s intervening decision to use his GPOA to appoint to the appointees. Thus, if W were H’s heir at law and/or sole residuary beneficiary outright under his Will, there would be no taxable gift (because W would be gifting to herself), and yet, H may have appointed those assets elsewhere, to a trust that may or may not include W. This leads us to the more important subtopic of how the step up in basis works, after which we will address ways to integrate the two statutes into planning and use savings clauses to prevent estates from the potential negative interpretations.

f. \textbf{Into the Wind of IRC §1014(e) – Tacking to Increase Basis Despite the One Year Rule}

Some of the PLRs referenced below, like PLR 2006-04028 and PLR 2004-03094, do not even address IRC § 1014(e). PLRs 2002-10051 and 2001-01021 and TAM 9308002 under

\begin{itemize}
\item \textbf{171} Treas. Reg. §25.2511-1(h)(1), see also PLR 9114023
\item \textbf{172} Of course, these deductions are based on what the donee receives, which, depending on the valuation of the business before and after, may not increase by the full $1.2 million – it may increase by less.
\item \textbf{173} Treas. Reg. §25.2511-1(e)
\end{itemize}
similar facts did address this issue, and would deny the step up.\textsuperscript{174} Or would they? The PLRs merely say that “Section 1014(e) will apply” – they do not say how and to what extent. And the TAM addressed an outright to spouse scenario rather than a typical trust bequest.

Here is §1014(e) in its entirety for better understanding:

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

Did H “acquire the property by gift”? Arguably, H never received the property – for the same good reasons that argue \textit{against} the marital gift tax deduction under IRC §2523 – he was dead at the time of the completed gift, so how can a corpse receive a gift? Quite simply, the property was never “acquired by the decedent by gift”. Although Congress is not required to be consistent or even logical, the interpretation of these two sections should be consistent regarding the tax treatment of a transfer occurring at death. Either a court should deem the recipient alive at the moment of transfer, in which case §2523 AND §1014(e) apply, or, you deem the recipient dead at the moment of transfer, in which case NEITHER §2523 NOR §1014(e) apply.

While some practitioners scathingly dismissed the former interpretation as a “gift to a corpse”, it is just as logical to say that you cannot have a “gift to a corpse” for §1014(e). The IRS may ultimately have been quite savvy to have allowed the former interpretation, in that

\textsuperscript{174} From PLR 2002-10051 - “In addition, section 1014(e) will apply to any Trust property includible in the deceased Donor’s gross estate that is attributable to the surviving Donor’s contribution to Trust and that is acquired by the surviving Donor, either directly or indirectly, pursuant to the deceased Donor’s exercise, or failure to exercise, the general power of appointment over the Trust property.” PLR 2001-01021 has near identical language.
consistency would assure that §1014(e) also applies, and that interpretation may ultimately be more valuable to the federal fisc.

Let’s assume H did “acquire” the $2 million “by gift” prior to death (consistent with the IRS’ §2523 rulings in the four PLRs/TAM) and address the second prong of §1014(e). Is it “acquired by the donor”? The simple answer in our case is “no”, it is acquired by a trust in which the donor is a beneficiary. But trusts are simply legal fictions dividing legal and equitable title, obviously W is acquiring part of the equitable title. In addition, PLRs 2001-01021 and 2002-10051 cite the Congressional record – §1014(e) should apply to property “acquired by the donor…indirectly”. One recent prominent tax court case ruling appears to indicate that a trust back to a donor/spouse within one year should not trigger IRC §1014(e), or at least that the IRS and tax court are ignoring the issue.175

IRC §1041(e)(2)(B) contemplates this possibility by specifically including someone who inherits outright through an estate or trust “to the extent the donor …is entitled to proceeds from such sale”. But what to make of the first part of that sentence – does it only affect basis when sold – what about for depreciation purposes? What about tax-free exchanges, distributions? (an interpretation requiring later tracing makes little sense, and would cause bizarre “springing step downs in basis”, but (e)(2)(B) arguably does this).

Most articles on this subject conclude that §1014(e) applies either 100% or 0% in our example of assets left in trust for W- but basic equitable law and trust valuation principles, coupled with the above language, argue that the step up for appreciated assets should be pro rated based on the valuation of the underlying equitable interests, based on the age of the donor/beneficiary and the terms of the trust. In other words, perhaps (e)(1) applies once the estate and/or administrative trust is settled, regardless of later sales, based on ultimate equitable ownership. This is only my theory – there is no clear guidance here at all.

What if the surviving spouse were merely a discretionary beneficiary? Arguably in many states, as asset protection attorneys will tell you, a spouse with a mere discretionary interest has no property interest under state law, and the value of the spouse’s interest

175 Estate of Kite v. Commissioner, T.C. Memo 2013-43, fn 9 – wife funded trust for husband, who died one week later, assets came back to wife in trust and the tax court noted without discussion that “All of the underlying trust assets, including the OG&E stock transferred to Mr. Kite in 1995, received a step-up in basis under sec. 1014”
should be $0. Many divorce courts and state marital dissolution laws will consider trust assets of a divorcing spouse only to the extent “vested” – the terms of the trust make a huge difference. However, the IRS is very likely to see this as some form of equitable ownership with value. In one recent private letter ruling where a beneficiary was a discretionary beneficiary of income and/or principal and had no need or history of receiving distributions, the IRS nevertheless said this interest had some value for gift tax purposes when it was proposed to distribute some principal to the remaindermen.176

And what does it mean for a spouse to be “entitled to the proceeds from such sale”? Even in a trust in which the spouse is entitled to all net accounting income, this doesn’t extend to capital gains from a sale of property, which typically get added to principal. Under most trust designs, the spouse would not be entitled to any proceeds from the sale. Is actual receipt and tracing required for 1014(e) to apply? It’s a terribly written statute.

But there are simple planning techniques that avoid the above nuances and ensure a full step up. First, of course, practitioners should make sure that only the surviving spouse’s share of assets where the step up is warranted are subject to the GPOA, so at least any step down is avoided (see sample clause in appendix and discussion in Part III). Recall that IRC §1014(e), craftily, does not apply to “depreciated” property and cannot be applied to deny a step down in basis.

Furthermore, to make it clear that IRC §1014(e) should not apply to the appreciated assets, yet retain nearly the same access for the surviving spouse, consider making the surviving spouse a permissible appointee of such trust under a child or other party’s lifetime limited power of appointment, rather than a beneficiary.

Example #2: John and Jane, with children of the same marriage, each have $1 million of low basis property, and $1 million of cash equivalents, retirement plans, annuities, property with basis higher than FMV etc. John and Jane give each other a formula testamentary GPOA over each other’s low basis property (this could be via joint trust, but my preference is still to

176 PLR 2011-22007
use separate trusts). John dies. He leaves his $2 million to an OBIT trust for Jane (although he would likely leave retirement plans and annuities to her outright). Jane keeps her $1 million of cash, retirement plans, annuities, high basis “loss” property”. John appoints Jane’s $1 million low basis property over which he had a GPOA to a Power Trust with their children as beneficiaries in a pot trust, granting each of the children the lifetime limited power to appoint (“LLPOA”) income and/or principal to Jane for whatever reason. This should result in a full step up in basis despite IRC §1014(e) because the funds are not coming back to Jane nor to a trust in which she is a beneficiary. Giving each child an LLPOA is to prevent the King Lear effect – as long as one of the children is a Cordelia rather than a Goneril or Regan, Jane should be fine. For an extensive discussion of the other asset protection benefits of “Power trusts” as opposed to self-settled DAPTs, email the author for a separate outline.

Using OBIT/JEST techniques at the first death for a married couple brings up additional planning techniques and concerns. First, despite the four PLRs discussed, to be conservative we should assume that §2523 will not apply (which enables us to circumscribe the GPOA for better asset and family protection as discussed in Part V above), and the technique will use TWICE the exemption amount (e.g. appointing $1 million will cost $1 million from both H’s and W’s AEA). For 90% of the population, this is still a winning deal, but we would be more selective with assets over which the GPOA applies for those with total estates over $5 million – favoring depreciable real estate that gives the surviving spouse a tax write-off, for instance, rather than artwork, home, etc that might not be sold until after the surviving spouse’s death. Let’s modify our example above with double the assets.

Example 3: John and Jane have $4.5 million each, comprised of $1.5 million in QP/IRA/annuities, $800,000 vacation home in JTWROS, $200,000 in art, autos and furnishings, $500,000 cash equiv, $1 million stock portfolio, $500,000 rental property JTWROS with low basis. A GPOA over all the assets, as in the PLRs, could be disastrous here, if §2523 does not apply, but often couples won’t need or use the step up at first death – the vacation home won’t be sold until after the first death, and wouldn’t be entitled to depreciation anyway, same with the art and cars. So, the GPOA in this case might be modified to apply to only the rental property and stock that has appreciated more than 25%. Let’s say that is $1 million. If
§2523 does not apply, and John dies, his DSUE is reduced by $1 million. For simplicity, assume Jane inherits John’s other assets outright or in marital trust, so her remaining AEA is only $8.5 million due to the two $1 million transfers. However, she obtained the step up which could save her significant income taxes in retirement, and her remaining estate is only $8 million. The inefficient use of exemption may be a moot point, especially if Jane decides to make some charitable bequests in her estate. In fact, couples without children often have significant charitable intentions – such techniques should be strongly considered for them, even those with larger estates, as noted above.

Flexible Provisions for Lifetime GPOA Trusts (aka JESTs) Using OBIT Techniques to Adapt to Either Interpretation of §2523/§1014(e)

As discussed above, when wife grants husband a lifetime or testamentary GPOA over her (or trust’s) assets, at H’s death, there is a taxable gift of the amounts subject to that GPOA – we just don’t know whether it will ultimately be interpreted as a gift in which §2523 allows the marital deduction (or the extent of §1014(e) vis a vis trusts).

Can we adapt our planning to either interpretation? For instance, a couple might prefer that if §2523 allows the marital deduction, such that §1014(e) would apply if the spouse is the beneficiary of the appointive trust, that the spouse is removed as beneficiary altogether, or made a purely discretionary beneficiary to better ensure the step up. The surviving spouse may remove him or herself as a current beneficiary through a qualified disclaimer, of course, but that assumes that you know the answer to that question within 9 months of the date of death (or 15 months, if a Clayton QTIP structure is used and a six month extension is granted to file the Form 706). Or does it?

Recall the Treasury guidance cited earlier in this article on formula disclaimers?177 Disclaimers don’t have to be over an entire estate or trust or IRA, they can be over any asset, and can reference a tax determination that may be years later in coming. Could the language be adapted as follows, substituting the appointive assets in question for the entire estate, and income tax reference for the estate tax reference: “The numerator of the fraction disclaimed

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177 Treas. Reg. 25.2518-3(d), Example 20: “A bequeathed his residuary estate to B. B disclaims a fractional share of the residuary estate. Any disclaimed property will pass to A’s surviving spouse, W. The numerator of the fraction disclaimed is the smallest amount which will allow A’s estate to pass free of Federal estate tax and the denominator is the value of the residuary estate. B’s disclaimer is a qualified disclaimer.”
is the smallest amount which will allow the appointive assets to pass with an adjustment to
date of death basis under IRC §1014(a) and (b) and free of application of IRC §1014(e) and the
denominator is the value of the appointive assets.” If the IRS settles on a “gift to spouse at
death” interpretation that permits a step up in basis even if the spouse is a beneficiary, the
“smallest amount” disclaimed will be $0. If the IRS settles on a “gift to spouse at death”
interpretation that would deny a step up under IRC §1014(e) if the spouse were a beneficiary,
then the “smallest amount” under the above disclaimer will the entire amount, the spouse is
removed as a beneficiary (but might remain a permissive appointee), and the trust assets can
still achieve the step up in basis.

QTIP elections can be by formula referencing the federal estate tax situation of the
decedent.178 Protective elections are also specifically permitted.179 But there is no reason it
has to be a zeroed-out formula, nor any reason such a formula cannot include more than one
factor. So, if the decedent-spouse appointed to a QTIPable Trust with Clayton provisions,
what if the executor makes a QTIP election over such amount (numerator) necessary to zero
out the estate tax, plus any such additional amounts comprising of lifetime gift tax exclusion
used by the surviving spouse as a result of the death of the decedent spouse?

Alternatively: what if the testamentary GPOA in question were only granted to the
decedent spouse using language similar to AB marital trusts? So, back to our example #3,
Jane’s trust might say “At my husband’s death, if I survive my husband, he shall have a general
testamentary power to appoint the Qualified Appointive Property. Qualified Appointive
Property shall mean such property, or its proceeds, in the trust estate that, if given outright to
my husband at his death, would qualify for the marital deduction for purposes of determining
the gift tax payable because of the transfer made complete at the death of my husband.”

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178 Treas. Reg. §20.2056(b)-7(h): “Example 7. **** D's executor elects to deduct a fractional share of the
residuary estate under section 2056(b)(7). The election specifies that the numerator of the fraction is the
amount of deduction necessary to reduce the Federal estate tax to zero (taking into account final estate tax
values) and the denominator of the fraction is the final estate tax value of the residuary estate (taking into
account any specific bequests or liabilities of the estate paid out of the residuary estate). The formula
election is of a fractional share. The value of the share qualifies for the marital deduction even though the
executor's determinations to claim administration expenses as estate or income tax deductions and the final
estate tax values will affect the size of the fractional share.”

179 Treas. Reg. §20.2056(b)-7(c)
Would such a precondition pass muster? Would the trend of the taxpayer victories in formula gifting cases such as *Wandry, Petter, Christiansen and Hendrix* help? Perhaps – but those concerned valuation rather than whether a gift qualifies for a deduction or not.

As complicated and uncertain as all of this is, we have not even addressed whether the IRS might make other arguments regarding §2523, such as whether the donee deceased spouse has a valid lifetime income interest that is not “terminable” at the time of death, or whether the infamous step transaction doctrine might apply. While there are plenty of cases where the IRS has argued “prearrangement” between spouses and lost, one of the most important “bad facts” for any step transaction case would be instantaneous successive transfers – an inevitable fact here.

In conclusion, until there is further guidance, wealthier couples with estates close to $10 million or above should simply avoid or narrowly tailor use of these joint GPOA techniques, *unless the bulk of their estate will go to charity at the second death anyway*, because of the potential for double use of exclusion as the price of the double step up in basis. They might consider a Community Property Trust instead. For couples with much lesser estates, there may be little to lose by attempting these techniques, especially if they are limited to the assets that would truly benefit the surviving spouse during his/her lifetime (e.g. near zero basis depreciable asset). At a minimum, the designs in the PLRs can be improved. In my opinion, the *Upstream Crummey Optimal Basis Increase Trust*, discussed in the next section, is far superior, because it largely avoids §2523, §1014(e) and step transaction issues.

g. The “Estate Trust” Alternative

Before turning to the Upstream Optimal Basis Increase Trust, let’s explain and compare a lesser known alternative to JESTs and CP Trusts – the Estate Trust.¹⁸⁰ Unlike a CP Trust or JEST, the estate trust is accomplished by making a completed gift in trust during lifetime (similar to the Upstream Crummey Trust discussed in the next section – see comparison chart). This enables the trust to escape the potential §1014(e) one year trap as long as the donee spouse outlives the donor by one year.

¹⁸⁰ See LISI Estate Planning Newsletter #2094, *David Handler & the Estate Trust Revival: Maximizing Full Basis Step-Up*
In contrast to the Upstream Crummey Optimal Basis Increase Trust, however, the amount of the gift to the Estate Trust can be unlimited, due to qualification for the gift tax marital deduction.

How does this type of trust work? Settlor transfers assets in trust for spouse, and spouse alone – but the trust does not require all net income be paid, like a QTIP or GPOA marital trust under §2523 (discussed in Part II) – payment of income and principal can be discretionary. The reason the gift still qualifies for the marital deduction is that the gift is not “terminable” – any assets remaining in trust at the spouse’s death must be payable to the spouse’s estate (not with permission of non-adverse parties, or subject to other contingencies). Thus, step one is fairly simple and easier to understand and accomplish – settlor transfers $1 million of appreciated securities, for example, to spouse in an estate trust. It is clearly included in the spouse’s estate, eligible for §1014 step up, subject to §1014(e) as discussed above.

The trickier step is how to also include the trust in the settlor’s estate, to enable the assets to receive a step up in basis at either spouse’s death, while still accomplishing a completed gift necessary for the marital deduction for the gift to the spouse. To accomplish this trick, it may be necessary to use an independent trustee. Treas. Reg. §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.”

However, Treas. Reg. §25.2511-2(d) provides that a gift will not be considered incomplete if the donor merely reserves the power to change the time or manner of enjoyment of the trust property:

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 retain the power to alter the manner or timing of the spouse’s beneficial enjoyment of the income and principal, but would not be able to name new beneficiaries or change the interests of beneficiaries as between themselves. Thus, a gift to an Estate Trusts will be a completed gift, yet be enough of a string to trigger IRC §2038/2036. This string would include the ability, for instance, to 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). Retaining this power will cause the trust property to be included in the grantor’s estate under §2038, yet not so much to impugn the completed gift.

The issues with Estate Trusts are that independent trustees are recommended, rather than husband/wife as usually contemplated by JEST trusts and often desired by clients. Moreover, there are much larger holes in the creditor protection and fidelity to the estate plan than JEST or OBIT trusts – there is no way to restrict or tie up the surviving spouse’s ability to completely and utterly control the estate, or encumber or jeopardize it with debt or liability. Unfortunately, you cannot simply translate the estate trust concept to an inter-vivos QTIP, because the code specifically states that a valid QTIP trust is not in the donor’s estate.

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181 IRC §2038 is broader than garden variety revocable living trusts: “To the extent of any interest therein of which the decedent has at any time made a transfer (except in case 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 during the 3 year period ending on the date of the decedent’s death. Treas. Reg. §20.2038(a)-1 also makes it clear that mere veto power over distributions or the ability to affect timing can trigger 2038, even if the ultimate gift may be complete: “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.”

182 IRC §2523(f)(5)(A)(i) “such property shall not be includable in the gross estate of the donor spouse”, inter vivos marital trusts granting a spouse a GPOA rather than QTIP have a similar clause in §2523(e)(2)
h. “Naked” GPOAs: the Promise and the Limits of Upstream Basis Planning

One may be tempted in the understandable zeal to exploit GPOAs for basis planning to extend the concept even further. Can I give my 95 year old poor grandmother a GPOA or LPOA triggering the Delaware Tax Trap over $5 million of my trust assets? How about an entire religious order taking a vow of poverty, scant acquaintances or other poor and huddled masses yearning to be free? Testamentary GPOAs exist even if the power holder has no access to corpus during the power holder’s lifetime – indeed, the powerholder’s lifetime interest is completely irrelevant. But the reason there is decades of precedent in favor of finding GPOAs even in the most extreme and dubious conditions is that the IRS always had a monetary incentive to so argue – can such precedents simply be abandoned by the courts? For TAMs, PLRs, yes – for code, regulations and court cases, no. Despite a surfeit of the latter, practitioners should be skeptical in such extreme and arguably abusive cases.

Ultimately, courts will have to sort out these limits. An apt analogy is the court-sanctioned use of Crummey powers (which are essential presently exercisable general powers of appointment anyway) for those with some modicum of trust interest (so called Cristofani beneficiaries), as opposed to so called “naked Crummeys” (those with no other trust interest other than the PEG power). So, is grandma a discretionary beneficiary or does she actually receive some income from the trust? Analogizing to Cristofani, the GPOA should be upheld. Despite all the favorable precedence, it is prudent (and probably in keeping with settlor intent), that a power holder has at least some discretionary interest; ultimately, other GPOAs may be ignored as sham transactions.

Outright upstream gifts are unrealistic, impractical and undesirable on many counts – what if the upstream beneficiary does not have good automobile, umbrella or long-term care insurance or might disinherit you in favor of your brother or the local church! Granting a GPOA to someone over revocable trust assets is a disaster – a taxable gift at death, and no step up in basis under the one year rule. Obviously the best protection from those risks is to use a discretionary trust coupled with a narrowly crafted testamentary GPOA or alternatively, a narrowly crafted LPOA triggering the Delaware Tax Trap, rather than outright gifts.

183 IRS Technical Advice Memorandum (TAM) 2009-07025
The Upstream Crummey Optimal Basis Increase Trust  

“The major purposes of the federal gift tax statute [is to protect] the estate tax and the income tax”

The $5.34 million (and rising) estate and gift tax exclusion is more than just an estate and gift tax benefit. For 99 percent of the population, it is now more appropriately considered an income tax planning tool. Many planners used to colloquially refer to the estate tax exclusion as a “coupon” not to be squandered when explaining the benefits of bypass trusts to save estate taxes. We should equally see this amount as an income tax shifting and basis increasing “coupon” not to be wasted.

Let’s explore “upstream” planning: why spouses, parents, grandparents and/or other older relatives should be considered as beneficiaries of Crummey trusts, even for smaller non-taxable estates, and why these same trusts should grant these same beneficiaries optimized powers of appointment. Such planning may also get around many of the issues involved in trying to achieve an increase in basis at the death of the first spouse to die for a couple’s assets even when the assets are not community property, discussed in Part V of this paper.

Let’s start with a common planning scenario and example of the technique and then analyze the possibilities, issues and limitations:

Example: John and Jane are in their late-60s, married, with 3 children, 5 grandchildren and 2 parents still living in their 90s. Together they have an $8 million estate, part of which is a $1 million fully depreciated property with only $100,000 basis owned by John. John gifts $140,000 to a standard grantor Crummey trust (aka, a spousal lifetime access trust, or SLAT) for his wife and family. However, unlike an ordinary Crummey trust that only names “downstream” relatives, John also includes his mother and father in-law. Each beneficiary has Crummey powers. The trust purchases John’s real estate for $1 million, with a small down payment and a remaining note at the applicable federal rate (AFR) or higher. With clear revenue rulings on point, this installment sale is typically ignored for income tax purposes.

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184 Portions of this section were published in The Upstream Crummey Optimal Basis Increase Trust, May 2014 issue of CCH Estate Planning Review
186 This technique could certainly be done with other non-depreciable property or use continuing annual Crummey gifts, but this article will keep the example stark and simple in order to more easily follow the concepts.
At first blush, this transaction is the exact opposite of what we have been advising in recent years: low basis assets (especially those subject to 28 percent or 25 percent federal tax rates) are often the worst assets to give and remove from someone’s estate in many cases. Moreover, John is “freezing” his estate and lowering the potential basis step up when he’s nowhere close to needing a freeze to save estate taxes. Is John nuts? But what if John does something quite different here: his trust grants his wife, mother and father-in-law a narrowly crafted testamentary power of appointment. Like over 99 percent of the population, his wife, mother and father-in-law have smaller estates than their available applicable exclusion amount.188

When one of them dies, the building will be included in the decedent’s gross estate under IRC §2041 and receive a new basis stepped up to the fair market value of the property pursuant to §1014 (provided one year has passed and §1014(e) would not otherwise apply). Let’s say its value increases to $1.1 million by that time (if no capital improvements are made, the basis may reduce even further if it is depreciable). If the appointive trust continues as a grantor trust as to John or Jane, or appoints to either of them directly, they can now depreciate the building with the new $1.1 million fair market value basis.

The Leveraged Upstream Optimal Basis Increase Trust - Let’s examine the deductibility of the debt and “basis for debt” rules a bit further – some may think it sounds too good to be true. In our example above, whether the debt is deductible may be irrelevant if the power holder has at least $1.1 million of available exclusion coupon to utilize. But what if we added an extra zero - $11 million of assets, with $9.6 million of debt? With significant leverage and values above the power holder’s available applicable exclusion amount, the deductibility of the debt becomes crucial to the estate inclusion and step up in basis.

Let’s review the historical tax background and regulations in this area. The granddaddy of income tax basis cases is the U.S. Supreme Court case of Crane v. Commissioner.189 In Crane, a widow inherited property encumbered by a nonrecourse liability equal to the value of the property. The property was sold several years later. In determining the amount of gain

188 The appointive assets subject to the power would typically be capped to the powerholder’s available applicable exclusion amount, or to the available state estate tax exemption.
189 Crane v. Commissioner, 331 U.S. 1 (1947).
realized on the sale by the beneficiary, the court held that the beneficiary’s basis in the property was equal to the appraised value at the time of inheritance minus subsequent depreciation, but that the amount realized included the buyer’s assumption of the non-recourse debt. Important to our analysis, the property received a basis step-up on the previous death of her husband – not just the equity, but also the nonrecourse liabilities to which the property was subject at death.

Let’s examine some of the tax code and regulations. IRC §2053 provides that:

“Expenses, indebtedness, and taxes
(a) General rule. For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts—

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(4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent’s interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate, as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.”

The regulations mostly mimic the code section, but add a sentence on nonrecourse debt:

Treas. Reg. §20.2053-7 Deduction for unpaid mortgages. “A deduction is allowed from a decedent’s gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. But if the decedent’s estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be retuned as part of the value of the gross estate.

Thus, the central question in our hypothetical becomes – when John sold the property to the irrevocable grantor trust (upstream optimal basis increase trust) for the down payment and a note, did he retain a mortgage, indebtedness, security interest or lien on the property to the extent of the debt, or does the trust simply owe the money and there is no security interest in the property? In the former instance, §2053 would permit the deduction upon inclusion of the property in the power holder’s estate, since the debt is tied to the property. In the latter

190 IRC §2053
191 Treas. Reg. §20.2053-7
instance, it would not. A general, non-secured debt of the trust would not enable a deduction for the power holder’s estate, unless it could be deemed a claim against the power holder’s estate, which may depend on state law, as discussed in Part III. The last sentence of Treasury Regulation §20.2053-7 quoted above tells us to report the value of the net equity on the Form 706 (not debt listed on Schedule K) when dealing with non-recourse debt. Does the decedent power holder (John’s mother or father in law in our hypothetical) owe on the debt as a co-signer or guarantor on the note with the trustee? This would be a “belt and suspenders” approach, but is probably undesired by the family and probably unnecessary – most readers have encountered many cases where the typical husband and wife will get a basis step up on their share (or in community property states, the entire share) regardless of whether only one spouse signed the mortgage.

So, for non-recourse debt, should we follow Crane, and assume any inheritor is going to get basis, despite a lower value reported (or reportable) on a power holder’s Form 706? Prudence dictates filing the lien (which might help with “reality of sale” analysis, since ordinarily unrelated parties secure large loans). Moreover, new basis regulations give a boost and confirmation to the argument that the tax basis rules enunciated in Crane still give basis for non-recourse debt following property to any inheritor, regardless of §2053 or how it would be reported on a Form 706, as discussed below.

If there is not land involved, but intangibles, a UCC filing should accomplish the same result as a recorded mortgage.\textsuperscript{192} After all, most substantial property and gifting involve closely held, usually pass-through, entities, with LLCs becoming the dominant choice. Importantly, tax partnerships (most LPs, LLCs) have their own separate treasury regulation governing basis upon death, which is quite favorable in our hypothetical:

\begin{quote}
§ 1.742-1 Basis of transferee partner’s interest.
The basis to a transferee partner of an interest in a partnership shall be determined under the general basis rules for property provided by part II (section 1011 and following), subchapter O, chapter 1 of the Code. Thus, the basis of a purchased interest will be its cost. \textbf{The basis of a partnership interest acquired from a decedent is the fair}
\end{quote}

market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of § 1.706-1 and paragraph (b) of § 1.753-1) under section 691. See section 1014(c). For basis of contributing partner’s interest, see section 722. The basis so determined is then subject to the adjustments provided in section 705.\textsuperscript{193}

So, let’s revisit our hypothetical using LLCs (not electing to be taxed as corporations), keeping the above in mind. John sets up an LLC, funds it with $140,000 cash, the LLC borrows $900,000 and purchases a $1 million building. The net equity is $140,000. He gifts 10% of LLC to spouse and 90% of LLC to an irrevocable upstream grantor trust (if the trust owns 100%, or if only he and his trust were owner, there would not be a tax partnership). Let’s ignore valuation discounts for simplicity (as discussed elsewhere herein and in other presentations, agreements can be manipulated to remove most discounts anyway). The upstream trust has an LLC interest worth approximately 90% of $140,000. The basis, of course, is much higher because of the debt - $810,000 higher. Let’s say the property increases in value 50%, $500,000, from $1 million to $1.5 million - and we’ll just ignore subsequent income/depreciation, and assume interest but not principal is paid on the loan for simplicity. The value (again, ignoring discounts applicable to a 90% share) of the 90% LLC interest in the trust is now 90% of $640,000 = $576,000. The power holder dies, bringing the trust into the power holder’s estate. The basis in the hands of whomever subsequently inherits the 90% LLC interest should be, pursuant to Treas. Reg. §1.742-1 above, $576,000 (the fair market value of the interest on the date of death or alternate valuation date), plus the successor’s share of partnership liabilities (90% of $900,000, or $810,000) = $1,386,000. In other words, the successor is getting FMV basis, plus additional basis for debt. This is true even if the power holder would only report the net $576,000 as the value of the LLC interest in the power holder’s estate tax return (if the power holder is even required to file).

**New Basis Rules under 1014(f) should have no impact, and reinforce the above rules**

The 742 regulation explains and solves our most common basis issues, but some may be wondering if Congress recently threw a monkey wrench into this analysis, at least where non-

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\textsuperscript{193} Treas. Reg. §1.742-1
recourse debt is concerned, in enacting the new basis reporting rules under §6035 and §1014(f), because they appear to set a cap for basis based on the value reported for estate tax purposes, which in some cases, as noted above, excludes nonrecourse debt.

(f) Basis must be consistent with estate tax return. For purposes of this section—

(1) In general. The basis of any property to which subsection (a) applies shall not exceed—

(A) in the case of property the final value of which has been determined for purposes of the tax imposed by chapter 11 on the estate of such decedent, such value, and

(B) in the case of property not described in subparagraph (A) and with respect to which a statement has been furnished under section 6035(a) identifying the value of such property, such value.

(2) Exception

Paragraph (1) shall only apply to any property whose inclusion in the decedent’s estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate. ¹⁹⁴

Thankfully, the proposed regulations clarify that this new code section should not affect additions to basis for debt above the value reported on the Form 706— the basis for the inheritor, and that reported under §6035 and Form 8971, includes the nonrecourse debt:

Example 4. (i) At D’s death, D’s gross estate includes a residence valued at $300,000 encumbered by nonrecourse debt in the amount of $100,000. Title to the residence is held jointly by D and C (D’s daughter) with rights of survivorship. D provided all the consideration for the residence and the entire value of the residence was included in D’s gross estate. The executor reports the value of the residence as $200,000 on the return required by section 6018 filed with the IRS for D’s estate and claims no other deduction for the debt. The statement required by section 6035 reports the value of the residence as $300,000. ¹⁹⁵

Example 1. (i) At D’s death, D owned 50% of Partnership P, which owned a rental building with a fair market value of $10 million subject to nonrecourse debt of $2 million. D’s sole beneficiary is C, D’s child. P is valued at $8 million. D’s interest in P is reported on the return required by section 6018(a) at $4 million [note the IRS did not apply any valuation discounts – that may or may not be accurate depending on the partnership agreement, etc]. The IRS accepts the return as filed and the time for assessing the tax under chapter 11 expires. C sells the interest for $6 million in cash shortly thereafter. (ii) Under these facts, the final value of D’s interest is $4 million

¹⁹⁴ IRC §1014(f), added by the
Thus, we can see that leverage inside of an LLC, which is the most common use for this planning, will not impair an increase in basis to any inheritor, even if only the net equity value is what is reported on the decedent power holder’s estate tax return. Thus, to use an extreme example, a decedent power holder with a $450,000 estate or less of their own personal assets, who controls, via testamentary GPOA, a 50% of an LLC (ignoring discounts) that owns a $100 million LLC with $90 million of debt and zero basis, will report $5 million on their estate tax return pursuant to Treas. Reg. §1.742-1 and the inheritor’s basis will be $5 million plus the $45 million, which is the inheritor’s share of the LLC’s debt, or $50 million. To quote the new proposed regulations, “The existence of recourse or non-recourse debt secured by property at the time of the decedent’s death does not affect the property’s basis, whether the gross value of the property and the outstanding debt are reported separately on the estate tax return or the net value of the property is reported. Therefore, post-death payments on such debt do not result in an adjustment to the property’s basis.”

**Crafting the power**

The testamentary power can be granted to only the first to die (*a reverse tontine*), to avoid any issues with a lapse of the remaining powers, but of course, similar powers might arise in subsequent appointive trusts, allowing a cascading increasing basis with additional disregarded purchases between the settlors and their grantor trusts.

The testamentary power could be a general power or a limited power exercised in such a way as to trigger the Delaware Tax Trap. Either one can be very narrowly crafted, as discussed in Part III. Although there are differences between these two methods of estate inclusion,

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**Footnotes:**


198 *A “tontine” is an annuity, insurance or trust arrangement wherein all the benefits go to the last survivor of the pool. They were quite common hundreds of years ago but more likely encountered by readers today in novels or in episodes of M*A*S*H or The Simpsons. I do not know if there is a historical precedent for a “reverse” tontine where the first beneficiary’s to die’s estate receives the spoils rather than the last survivor’s, but that is the concept here.*
either one may achieve the same result of a step up in basis. Which method to choose may depend on state creditor and asset protection trust law, the financial position of the parent and the importance of continuing asset protection, grantor trust status and/or control to the settlor, as discussed in Part III.

To ensure qualification for the annual exclusion gift under the Crumney case and its progeny, the attorney might consider denying application of the testamentary general power of appointment to any amount of the trust still subject to a withdrawal power (which typically lapses 30-60 days after the gift). Otherwise, there is a remote chance the IRS could argue there was no “present interest” due to the possibility of a powerholder dying before the beneficiary had an exercisable right to demand the gift. This tack is probably overly conservative – there is no case denying the annual exclusion for any similar provision, the death would probably be considered an act of independent significance, it’s not so different from the remote chance of someone stealing the money or losing the funds with a bad investment, and the IRS can’t help but lose every Crumney case it tries to attack. Nevertheless, in most cases this provision would not impair any benefits.

Another method of ensuring a present interest, yet enabling a testamentary power that could still step up the basis in the assets, would be use a limited testamentary power of appointment that could only appoint to a trust which keeps the existing withdrawal right intact – as discussed in Part III of this paper, because such a trust would have a presently exercisable general power of appointment (Crumney power), the exercise of the limited power of appointment would trigger the Delaware Tax Trap under most every state law.

If the powerholder dies within one year of the gift, a step up is denied if the same assets come back to John or Jane outright, under IRC §1014(e). If the assets pass to a trust for either of them within one year, the issue is much murkier, and it may well depend on the terms of the trust and even, surprisingly, whether the property is sold.199 To avoid some of those issues John’s trust may require a one-year curing period before any testamentary GPOA/LPOA is effective, the power holder may appoint the property gifted within one year to a non-donor

199 See Part V, and more recent LISI Estate Planning Newsletter #2192, Jeff Scroggin: Understanding Section 1014(e) & Tax Basis Planning, and LISI Estate Planning Newsletter #2194, Jeff Scroggin & Michael Burns on Tax Basis Planning: The Basics, LISI Estate Planning Newsletter #2203, Alan Gassman, Christopher Denicolo and Ed Morrow Response to Jeff Scroggin’s Commentary
child and bequeath other property of equal value to the donor child, the successors might simply avoid sale of property until the next death and still exploit the additional depreciation, or simply take care that any permitted appointment within one year would not include payment to them outright or to a trust for them that might be disqualified for a step up in basis. But even if some assets come back to the donor within one year, are they the same assets? Were those appreciated assets “acquired by gift” by the decedent power holder, as required by §1014(e)? Arguably no - if a donor puts in cash, and what comes back is real estate acquired by FMV purchase, the plain language of §1014(e) is not triggered.

But wait! Don’t “bad things” happen if someone dies with a note to a grantor trust outstanding? There has been spirited debate among practitioners about whether the death of a settlor of an irrevocable grantor trust in the midst of repayment of an installment sale note with the settlor triggers income tax on the sale at death. And there is a regulation to trigger gain to the extent the outstanding liabilities owed by the trust exceed the trust’s basis in the assets if such status changes during the grantor’s life.\textsuperscript{200} Thankfully, neither would be an issue here, unless John were to die first.\textsuperscript{201}

Why isn’t the powerholder’s death as negative for income tax purposes as the death of the settlor? Well, for one thing, the basis increases to the fair market value date of death, so the trust’s liabilities would unlikely exceed the basis, unless the value had gone down precipitously post-gift. But, more importantly, it is highly likely that the parent powerholder (or John, via lapse provisions in the trust) would structure any appointment or lapse so that the taxpayer does not change for income tax purposes anyway.

How does the family make this happen? Well, there is the startlingly simple solution that the parent GPOA powerholder can appoint the trust assets to John outright directly,\textsuperscript{202} or to Jane, his wife.\textsuperscript{203} Or to a revocable trust or any other trust that would qualify as a grantor trust

\textsuperscript{200} Treas. Reg. §1.1001-2, ex. 5.
\textsuperscript{201} To mitigate against that event, John might purchase life insurance and of course, if John becomes terminally ill or death is not sudden, he or his agent under a power of attorney would repurchase the assets before his death and cancel the note, substituting cash or even better, assets otherwise destined to be in his estate with higher basis than fair market value. But the odds of John suddenly dying before the other three without warning are extremely slim.\textsuperscript{202} This ability should not compromise the asset protection or completed gift status of the initial gift.\textsuperscript{203} Provided John and Jane are still married, this does not necessarily cancel the note or transaction for state property law, but Code Sec. 1041 expressly ignores sales/exchanges between spouses, which would of course include grantor trusts as to spouses as well, per Rev. Rul. 85-13. IRC §1041 is not exactly the same as Rev. Rul.
for them due to a withdrawal power over all taxable income and/or principal, as discussed in Part VIII.

But what if John and Jane want continuing tax or asset protection benefits of an irrevocable wholly discretionary trust? If the powerholder parent dies and exercises a GPOA to a trust for John or Jane, it is clear that the powerholder is the new grantor and the trust could only continue as a grantor trust as to them if a broad IRC §678(a) power applies, which would eliminate some, but not most, of the creditor protection and estate tax benefit of the new appointed trust. Ordinary exercises of limited powers of appointment clearly have no effect on the grantor for income tax purposes.

However, if the GPOA merely lapses, or a limited power is exercised in such a way to trigger the Delaware tax trap under IRC §2041(a)(3) or inclusion as an inter vivos QTIP, the issue is much murkier - would this be an indirect gratuitous transfer per §1.671-2(e)? The mere lapse of a GPOA does not appear to override §§ 671-677 for grantor trust purposes, not only because of its conspicuous absence of mention in paragraph (e)(5) of Treas. Reg. §1.671-2, but also under the subsequent example 9, wherein the exercise of a GPOA clearly changes the grantor, but the mere presence (and presumably, lapse) of one does not override the original settlor being grantor under IRC §§ 671-677. Lapses are not necessarily “transfers”.

85-13, however – the sale/exchange is ignored, but not necessarily the interest payments. See Gibbs v. Commissioner, T.C. Memo 1997-196 (T.C. 1997). However, this could very easily be fixed by later gift or sale.

204 See Reg. §1.671-2(e):
(1) For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust. ******
(2) (i) A gratuitous transfer is any transfer other than a transfer for fair market value.
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(5) If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.
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Example 9.
G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

205 Reg. §1.671-2(e)(5), above.
LPOAs triggering the Delaware Tax Trap are equally uncertain as to whether they override the original settlor’s grantor trust status. Does “generally” in the statute imply there are exceptions? Should limited powers that are treated like general powers for tax purposes be treated more like exercised GPOAs for income tax purposes?

Thus, if the parent’s GPOA merely lapsed at their death, and the trust continued with terms that kept John as a grantor under IRC §§671-677, such as power of substitution, provisions enabling income to be distributed to grantor or grantor’s spouse, etc., but no provisions that would trigger estate tax inclusion, then we apparently have the holy grail of a step up in basis, while keeping grantor trust status and still keeping the estate and asset protection benefits of the trust.

Not all taxpayers would prefer to keep grantor trust status, however – as discussed in Part VIII of this paper, clients may prefer to exploit a non-grantor trust to shift future income to children/grandchildren who are likely subject to lower income tax rates, get better charitable deductions that avoid Pease limitations and the 3.8% surtax and/or perhaps most importantly, avoid state income taxes.\(^{206}\) The change from a grantor trust to a non-grantor trust while the grantor is still living causes the grantor to be deemed for income tax purposes to have transferred the assets and liabilities to the trust. The trust becomes a separate taxable entity for income tax purposes, and the grantor is taxed on consideration received by the grantor in excess of the basis in the property transferred.\(^{207}\) This sounds bad, but in our case, the grantor would probably receive no consideration, and moreover, the basis would have been increased anyway by the power holder’s death.

But, doesn’t the IRS ignore everything having to do with a grantor and grantor trust for income tax purposes, and couldn’t this include application of Code Sec. 1014 in the above instance?\(^{208}\) Rev. Rul. 85-13 does generally ignore transactions between a grantor and a grantor trust, but here Code Sec. 2041 and Code Sec. 1014 is applying not because of any

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\(^{206}\) Many states, such as Maine, tax based in large part on the residency of the settlor. Since the exercise of a GPOA (unlike an LPOA) would likely create a new Settlor/grantor for state trust and tax law as well as federal tax law, if the powerholder is a resident of another state this may help avoid state income taxes, or even, in the case of New York, where the powerholder was a resident, since NY’s anti-DING legislation would no longer apply.

\(^{207}\) Madorin v. Commissioner, 84 T.C. 667 (1985); Treas. Reg. § 1.1001-2(c), Ex. (5); Rev. Rul. 77-402. Each of these authorities involves debt relief as consideration paid.

transaction between the grantor and his trust, but because of a powerholder’s action or inaction. These two statutes clearly apply to lapses of testamentary GPOAs as well as exercises.\textsuperscript{209}

But there is another potential quirk of Code Sec. 1014 that might apply: if the property is acquired before the decedent powerholder’s death, any step up is reduced by depreciation. This second sentence of paragraph (b)(9) is meant to compensate for “string” gifts of depreciable property brought back into a donor’s estate. Would that apply here? It should not: reading the paragraph in its entirety it is clear that “acquire the property” refers to receiving it from the decedent’s direct or indirect transfer. John would not be acquiring the property from the decedent, before the decedent’s death as with a “string” gift. However, if a practitioner feels the second sentence of Code Sec. 1014(b)(9) could apply here, the powerholder (or default upon lapse) can devolve the assets to the grantor’s spouse Jane instead (or a grantor trust therefore), or simply exercise the GPOA and forget trying to rely on a lapse - the exercise of a GPOA by will (as opposed to a lapse) comes under Code Sec. 1014(b)(4), not 1014(b)(9).\textsuperscript{210} Any such exercise should be careful to avoid being exactly the same as the taker in default.\textsuperscript{211}

Most taxpayers would prefer to keep things simple and more certain and be happy to receive the assets back outright, or in trust with a presently exercisable GPOA, or settle for a trust that grants a §678(a) power over income only. For poorer families where a power holder may be on Medicaid or otherwise close to insolvent, the use of limited powers of appointment

\textsuperscript{209}Code Sec. 1014(b)(9): “In the case of decedents dying after December 31, 1953, 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. In such case, if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent.” See also Treas. Reg. §1.1014-2(a)(4). Treas. Reg. §1.1014-2(b)

\textsuperscript{210}Code Sec. 1014(b)(4): "Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;"

\textsuperscript{211}If a power holder simply appoints to the exact same party that would have taken by default in absence of appointment, the appointment is deemed not to have been exercised and the assets pass by default. See Restatement Third of Property, Donative Transfers, §19.26, also Uniform Power of Appointment Act, §313
and the Delaware Tax Trap to trigger inclusion/step up should avoid any creditor/asset protection issues should the parent powerholder’s estate be insolvent or subject to claims.\textsuperscript{212}

Of course, these trusts are natural pourover vehicles for GRATs at the end of the annuity term, or, similar terms could be incorporated into the GRAT itself to be applied at the end of the term (an Upstream Optimal Basis Increase GRAT).

What about sham or economic substance arguments? In contrast to naming strangers, it is hardly a sham to name a parent as beneficiary of a family trust. Millions of people assist their parents financially anyway, so why not make those gifts from a trust best designed to benefit the entire family? An analogy for drawing the line may be made in comparing so-called “Vulture CLATs” using sick non-relatives as measuring lives, which the IRS ultimately shut down, with CLTs that use relatives, even sick relatives, as measuring lives, which is explicitly approved. Like regulations that govern using life expectancies of terminally ill relatives, §1014(e) effectively prevents “deathbed GPOA granting”.

The IRS has repeatedly tried these kinds of arguments against FLP/LLCs, Crummey trusts, spousal trusts and other various more egregious fact cases without success. It’s why every estate planning attorney comfortably drafts trusts for spouses and children without fear of “prearrangement” related arguments, even though parents are often forced by intestacy law to be beneficiaries of their minor children’s estates. It’s hardly a damning factor for an elderly parent to appoint trust assets back to their adult child any more than a spouse appointing back to their spouse in a SLAT or inter vivos QTIP or a child appointing to their parent as beneficiary if they predecease; rather, it’s completely natural. Even in an extreme case where the parent gifts to child and child gifts to trust for parent, the parent is not necessarily deemed the grantor.\textsuperscript{213}

To quote one recent tax court case:

\textsuperscript{212} Testametary general powers may or may not be subject to a powerholder’s estate’s creditors. Contrary to a popular myth disseminated by speakers at the 2014 Heckerling conference, third-party created testamentary GPOAs and LPOAs are generally not subject to state statutory share laws. See Uniform Probate Code §2-201, §2-205(1)(A), Fla. Stat. 732.2045, Bongaards v. Millen, 793 N.E.2d 335 (Sup. Ct. Mass. 2003)

\textsuperscript{213} The First Circuit overruled a lower court and held that such a scenario did not create deemed control/grantor status as to the father who was the original transferor to a trust for child, where child later transferred same funds to a new trust with father as beneficiary in Plimpton v. Commissioner, 135 F.2d 482 (1st Cir. 1943)
“A trust valid under state law can be treated as a nullity for federal income tax purposes if it lacks economic reality, but this would likely happen in only an extreme case. Four factors determine whether a trust has economic substance:

(1) Did the taxpayer’s relationship to the transferred property differ materially before and after the trust’s creation?
(2) Did the trust have an independent trustee?
(3) Did an economic interest pass to the other trust beneficiaries?
(4) Did the taxpayer respect restrictions imposed on the trust’s operation as set forth in the trust documents or by the law of the trusts?”

As long as an independent trustee is used, none of these four factors would even come close. Using a family member might be more likely to implicate the other factors listed, but it would still be a very rare and abusive case indeed for the tax court to invalidate a trust – the Close case even concerned a pro se taxpayer found guilty of fraud, money laundering and obstructing investigations and his trust was not busted - despite dubious circumstances and individual trustees.

What about the “step transaction” doctrine: could this be applied to ignore the taxable gift and power of appointment? This judicial doctrine generally requires several transactions that are so interdependent that they can’t be viewed separately, in order to collapse the steps into one integrated transaction. A court may invoke this doctrine when: (1) each step is connected by a binding commitment, (2) each step is mutually interdependent, or (3) a series of closely related separate steps to achieve an end result as part of a prearranged plan agreed to by all the parties prior to the transaction. The first two hardly apply, but the last one could with enough bad facts, such as a deathbed transaction, just as with many FLP/LLC or trust transactions. Just as with any other Crummey trust, FLP/LLC gift, or spousal transaction, parties should take precautions to avoid any hint of prearrangement with any power holders. But the IRS has lost much stronger cases where transactions occur only days apart, with the same parties involved, when it was clear to everyone involved beforehand what was going to happen.

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214 Christopher C. Close, et ux. v. Commissioner, TC Memo 2014-25
215 E.g., T. H. Holman Jr., CA-8, 2010-1 USTC ¶60,592, 601 F.3d 763, 770, 772 (2010)
By contrast, here, older power holders would not even be notified of the trust before its execution and many years may pass before a powerholder dies. During this time there would be ongoing trust administration, asset management and distributions. Older generation power holders would usually use a different attorney for their estate plan (and thus, appointments) as well. There is a not merely a risk of economic change of circumstance through trust administration by the time a powerholder dies, it’s a very high likelihood. This kind of “prearrangement” is not so different than someone using a bypass or QTIP trust and the IRS trying to deny the marital deduction by claiming it was all “prearranged” to pass to the couple’s children at the spouse’s death, or having an inter vivos marital trust flow back to the settlor – which is even sanctioned by regulation. Quite simply, the step transaction should not apply here. While nearly all trusts are motivated in part by tax considerations, trusts for parents and spouses, such as an Upstream OBIT, also have a strong independent purpose and economic effect, rather than no purpose or effect beyond tax liabilities.

Courts have been quite resistant to IRS attempts to inveigh prearrangement, implied promise or concert to invalidate a tax effect clearly permitted by law, even under much more dubious circumstances.

Advisor often ask whether this same technique can be accomplished by granting GPOAs to power holders in revocable trusts. Generally, NO – see detailed discussion above regarding JEST trusts. Not only would this cause a taxable gift to occur on the death of the power holder from the settlor to the power holder that would obviously not qualify for the marital deduction, but it would also fail under §1014(e) and cause a step down and not a step up,

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216 Treas. Reg. §25.2523(f)-1(f), Example 11, which provides that assets held in an inter vivos QTIP trust for the benefit of the settlor after the death of his or her spouse will not be includible in the settlor’s taxable estate under Code §§2036 and 2038

217 For example, the Fifth Circuit approved disclaimers by 29 devisees of Louise Monroe, some of whom were unrelated to her, made at the request of her husband's nephew. The disclaimers caused the disclaimed property to pass to the decedent's husband free of estate tax. Shortly thereafter, the husband made generous gifts to each of the disclaimants, in many cases equal to the amount disclaimed. The Tax Court had found that the disclaimers were unqualified because they were the result of an implied promise by the husband to make gifts to the devisees if they disclaimed. However, the Court of Appeals for the Fifth Circuit reversed that decision, stating that the very purpose of disclaimers is "to facilitate post-mortem estate tax planning and to increase family wealth on the 'expectation' that there will thus remain more wealth to pass on to the disclaimants in the future." Estate of Monroe v. C.L.R., 124 F3d 699 (5th Cir 1997).
because the transfer would be simultaneous, not just within one year. Not to mention that this would be much more likely than the “Crummey OBIT” to be a step transaction.

j. **Intra-Spousal Planning: Building on the Joint Exempt Step Up (JEST) Trust concept**

One of the potential issues in planning for a step up in basis for joint GPOA trusts (aka, JESTs) is the uncertainty of whether the gift tax marital deduction will apply for the first transfer of assets from the original owner/spouse to the first decedent spouse. The IRS could easily reverse their position on the marital deduction taken in several private letter rulings, since there are good arguments for and against. The Crummey Optimal Basis Increase Trust (OBIT) technique basically eliminates that concern altogether by substituting the marital gift tax deduction for this first gift with the annual exclusion gift tax deduction.

Let’s take the above example with John and Jane and assume instead that they have no parents or other older “objects of their natural bounty” living that they would want to name as beneficiary or grant a power of appointment. They are in a stable long-term marriage. If John structures the same transaction as above, this works well if his wife dies first, because it can clearly be included in her gross estate with a testamentary power of appointment and there is no potential issue as to whether the granting of the POA qualifies for the marital deduction under Code Sec. 2523. Unlike an inter vivos QTIP, we can also avoid step downs in basis and be much more flexible in planning.

Furthermore, there is much less likelihood of Code Sec. 1014(e) applying, since Jane will probably live a year after the transfer, and the trust, of course, can have springing GPOAs or alternative dispositions if Jane dies before or after one year of the initial gift to address that possibility.

But what if John dies first? If he has enough warning before death, he or his agent can swap assets, cancel the note and ideally put high basis assets in the trust. But sometimes life (and death) can surprise us. Could the family avoid that risk and trigger inclusion in his estate somehow?

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218 This is discussed in *It’s Just a JEST – the Joint Exempt Step Up Trust*, LISI Estate Planning Newsletter #2086 (April 3, 2013), by Gassman, Ellwanger and Hohnadell

219 IRC §2523 (lifetime marital gift tax deduction), IRC §2503(b) (annual present interest exclusion from gift tax)
Actually, triggering estate inclusion is easy through various retained powers; the more difficult task is triggering it without making the gift incomplete. This is the exact opposite of Delaware Incomplete Gift Non-Grantor Trust (DING) planning, where the goal is to deftly cause a transfer for income tax filing purposes but not gift tax purposes. It is completely opposite of how we typically planned pre-ATRA, or still plan for wealthier clients.

Generally, retaining a testamentary power of appointment or power of disposition makes the gift at least partially incomplete.\textsuperscript{220} Recall this recent stir caused by CCA 2012-08026 in which the IRS claimed that a mere testamentary POA retained is NOT enough to make a gift wholly incomplete, it merely makes the remainder interest incomplete, and the lifetime interest is complete.\textsuperscript{221}

If, however, a trustee via decanting or trust protector were to later grant a limited formula testamentary power of appointment to John, the gift will still have been complete, but there would now be a “string” causing partial estate inclusion to the extent of the power under § 2038.\textsuperscript{222} If there is a cap or limit on the power (e.g., as to the appreciated real estate, but not the cash or loss assets), this limit would correspondingly reduce the assets subject to inclusion under §2038.\textsuperscript{223} This is similar to the recent ruling outlining that only a \textit{portion} of a GRAT is included in a settlor’s estate under §2036 should they die during the annuity term.\textsuperscript{224} Furthermore, such a power could easily be removed or released later to remove the estate inclusion taint, though a formula might effectively avoid the need to.\textsuperscript{225}

However, such changes risk the IRS arguing that there is a prearrangement or step transaction with the trustee/trust protector (ergo, never really a complete gift), or that it will simply never be accomplished. Rather than relying on later changes, the settlor should simply retain a power that causes estate inclusion over only the intended assets, yet does not cause a gift to be incomplete. Only the power to “change the manner or time of enjoyment” would be

\textsuperscript{220} Treas. Reg. §25.2511-2, Cessation of Donor’s Dominion and Control.
\textsuperscript{221} CCA 2012-08026, in spite of a seemingly contrary treasury regulation at Treas. Reg. §25.2511-2(b).
\textsuperscript{222} It would not cause inclusion under §2041, since a settlor/donor cannot create a general power in him/herself
\textsuperscript{223} See Reg. §20.2038-1(a).
\textsuperscript{224} Internal Revenue Bulletin  2008-35 (of course, it could be 100% inclusion, it depends on prior rate of return, change in 7520; i.e. how much is needed to pay the remaining annuity)
\textsuperscript{225} Subject, of course, to the three year rule of IRC §2035.
retained. For example, the settlor could retain the power to veto early distributions of appreciated assets to beneficiaries. This would involve “changing the manner or timing of enjoyment”, enough to trigger §2038 as to those assets, yet not be so much as to “change the disposition” that would make the entire gift (or any part) incomplete pursuant to §2511.

If the trust is to be funded partially with Crummey gifts, and the settlor still wants to be able to cause estate inclusion, yet not cause a gift to be incomplete, care should be taken to avoid impairing the present interest. Retaining a veto power over the withdrawal right would likely negate qualification for the annual exclusion. Can we be certain that §2038 would be adequately triggered if the veto right only applied after the 30 day withdrawal period? While it probably would be, this issue could also be addressed by including the power to accelerate the timing of a beneficiary’s enjoyment, e.g. the trustee may distribute, and for 30-60 days the beneficiary may withdraw $28,000 worth of contribution to the trust. The Settlor retains the power to force the trustee to accelerate the distribution.

Attorneys should avoid pot trusts that permit unequal distributions to beneficiaries prior to division – if the settlor can veto one beneficiary’s distribution, but not another’s, then such a power would indirectly change the disposition of the trust as well as the timing. By contrast, if separate shares/subtrusts are used, or if unequal distributions are treated as advancements, then any veto would not change the disposition scheme, only the timing.

k. Crummey OBITs: Preserving Basis of Loss Property, especially Community Property

Let’s take a different spin and imagine that John and Jane also have a wonderful second home purchased at the height of the real estate boom – the basis is $1,000,000, but the fair market value is now only $600,000. If John or Jane dies and it is deemed community property, the entire asset is stepped down to a $600,000 basis. The same occurs even in a separate property state if both die (or, with discounting, it could be worse if the survivor does not own 100%), or if a spouse who is 100 percent owner dies. If it is held in equal joint tenancy with right of survivorship and one dies, the basis is still reduced, but only half as much.

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226 Treas. Reg. §20.2038(a)-1 – see further discussion in Part V.f. on page 77, footnote 156
227 Treas. Reg. §25.2511-2; contrast paragraphs (b) “complete”, with (d) “incomplete” – embrace (d), avoid (b)
228 IRC §2503(b)
229 IRC § 1014(b)(6).
230 IRC § 2040(b).
John can use a *Crummey* OBIT to prevent any step down in basis at John and/or Jane’s death. The transaction would in essence be similar to the above, but the GPOA or LPOA would only be active or be used to trigger estate inclusion at either of their deaths if the asset increases in value above the $1,000,000 basis. This preserves the higher $1,000,000 basis for the trust/family who later inherit, who might convert it to an asset held for investment and later sell or rent the property. One quirk to the carry over basis rules for gifts is that, if the family sells the property for anywhere between $600,000 and $1,000,000 (ignoring any later depreciation or capital improvements), there is neither gain nor loss.\[^{231}\] If the family later sells for $1.1 million, the capital gain is $100,000, not $500,000. If the family (trustee) later sells for $800,000, there is no capital gain (and no loss), not $200,000 in gain. Despite these limitations, saving $400,000 of basis can be a huge advantage for the family.

Note that in this instance, the debate about whether an ongoing installment sale triggers gain at death might still lead to some uncertainty as to whether a realization event occurs upon change to non-grantor trust status (though, presumably no gain in the above example). Thus, transfer to spouse, or completing the gifting using repeated annual exclusion gifts or gifts beyond the annual exclusion might be considered.

**Conclusion – Not limited to Crummey powers or real estate holdings**

The above examples used one parcel of real estate for simplicity, but this could easily be extended to a portfolio of stocks and bonds. The beauty of such planning is that, unlike an ordinary portfolio, the estate inclusion or exclusion via formula powers of appointment can adapt to a sustained dip in the market, as with the most recent financial crisis. We should not assume that clients and their spouses will not die during a market downturn (including the bond market, which is often overlooked by many planners as a potential source of volatility).

In the above example, we presumed that John and Jane would prefer to use annual gift tax rather than lifetime gift tax exclusion, but with $10.68 million, many taxpayers could make upstream gifts with impunity and simply forget about the *Crummey* annual exclusion gifts, or supplement them.

\[^{231}\text{IRC § 1015(a)}\]
We used a $1 million property in the above example, but remember that, with leverage and multiple older power holders, it might easily be $45 million or $90 million. In some circumstances, existing SLATs, IGTs and other previously funded trusts may be modified to exploit this. Part VII discusses tax aspects of modifications of existing irrevocable trusts.

The new paradigm in financial and estate planning is to view the applicable exclusion amount as more than a mere estate tax benefit, but as an asset to be used for income tax planning as well. Congress and the courts have appropriately called the gift tax a “back stop” to the income tax. Practitioners have a duty to explore the planning possibilities for families with that back stop effectively removed for over 99 percent of the population.

I. The “Can’t BDIT” - ensuring step up at settlor/parent’s death for BDITs

As discussed above, OBIT power of appointment strategies can build upon the JEST concept. What about another cutting edge strategy – the beneficiary defective irrevocable trust (BDIT)? Can we build a better BDIT? There are three potential perceived drawbacks to the BDIT strategy that this paper addresses – this section will suggest a solution to the first, and Part VIII will suggest a solution to the latter two and provide citations to relevant articles. But first, let’s review what the heck a BDIT is, and its pros and cons.

A BDIT is an inter vivos irrevocable trust. It is usually established by a parent for a child, but may involve other relationships. It attempts to thread a needle in three areas: income tax, estate tax and asset protection, with the most important differentiator from other third party created trusts being the income tax treatment.

For income tax purposes, its differentiating characteristic from other trusts lies in ensuring the trust is not a grantor trust as to the settlor, and that a withdrawal right causes the trust to be a “grantor” or, I prefer the term “beneficiary-deemed owner” trust as to the beneficiary pursuant to IRC §678(a). It does so by granting the beneficiary a Crummey power over the trust contribution – the lapse still deftly keeps the trust as a beneficiary deemed owner trust by keeping certain beneficiary retained rights pursuant to IRC §678(a)(2) and does not cause the trust to be self-settled by the beneficiary, by virtue of the IRC §2514 lapse protection and state law that typically references it. It can accomplish this feat without
sacrificing the estate tax and asset protection benefits of third party created trusts – that is, it should neither be in the estate of the settlor nor the beneficiary, nor be subject to their creditors, absent extreme scenarios such as a fraudulent transfer upon funding, or the beneficiary dying during the limited window of a withdrawal right.

The deeming of the beneficiary as the owner for income tax purposes, yet not for estate/gift/GST and asset protection purposes, allows for installment sales and disregarded transactions between the beneficiary who is deemed the owner of the trust and the trust, just as with settlors and their revocable or other grantor trusts. By contrast, transactions between a beneficiary and a non-grantor trust, or between a beneficiary and a grantor trust as to the settlor, would typically be taxable transactions.

Of course, settlors can attempt to accomplish a similar result by making completed gifts to an irrevocable grantor trust with themselves as a beneficiary, using an offshore or domestic asset protection trust statute, such as Nevada, Ohio or Delaware, that permits self-settled trusts. However, it is unclear how much protection courts in states without such statutes (including bankruptcy courts interpreting such statutes) will grant such trusts.232 This creditor protection uncertainty causes estate tax exclusion uncertainty. But even aside from that concern, because the settlor would have contributed funds to such a trust and remained a beneficiary (perhaps even a potential beneficiary via trust protector), it is uncertain whether IRC §2036(a) may cause estate inclusion as a retained interest even aside from the issue of estate inclusion due to creditor access.

It is for these reasons that taxpayers have turned to the BDIT if they have cooperative family members willing to make gifts – they can enjoy continued access to an irrevocable trust as beneficiary and continued ability to make tax-free transactions, with less asset protection and estate inclusion risk than a DAPT.

Those are the pros – what of the cons to this structure? There are three main ones: the first is the minimal amount, typically only $5,000, of the seed gift.233 The second is the uncertain conclusion of whether a lapse is a “partial release or other modification” necessary

232 In re Huber, 2013 Bankr. LEXIS 2038 (May 13, 2013)
233 Tied to the 5% or $5,000 lapse protection of IRC §2514(e). Advocates of BDITs contend that minimal seeding can be overcome with loan guarantees to enable larger transactions despite smaller seed gifts
for continued beneficiary-deemed owner status under §678(a)(2). These are addressed in
Part VIII. The last one is that, while 99.5% of taxpayers do not have taxable estates, and
parents establishing BDITs are often in this category, the lack of estate inclusion in the parent
completely wastes the parent’s $5.43 million (or higher) applicable exclusion amount and
misses an opportunity to step up the basis on any assets contributed to the BDIT, which may
include substantial assets sold to the BDIT for a note if growth exceeds the loan rate over
time, not just the $5,000 seed gift funding.

So, how do we ensure that the settlor parent retains enough power to cause estate
inclusion (with caps, of course), yet not so much of a power that would destroy the
beneficiary deemed owner status pursuant to §678(a)? How do we turn a BDIT into a “Can’t
Beat It”?

The answer is for the settlor to simply retain a power that causes estate inclusion over
only the intended assets, yet does not cause grantor trust status, nor cause a gift to be
incomplete, nor impair the withdrawal right necessary for §678(a) beneficiary deemed owner
status and present interest. This is not exactly a simple and straightforward exercise.
Counterintuitively, we’ll have to borrow some concepts from incomplete gift (ING) PLRs.

As discussed in Part V.i, we can cause targeted estate inclusion over completed gifts by
retaining only the power to “change the manner or time of enjoyment” of a gift - enough to
trigger §2038 as to those assets so targeted, yet not be so much as to “change the disposition”
that would make the entire gift (or any part of the gift) incomplete pursuant to §2511.

It’s especially difficult for Crummey gifts and BDITs, because not only do we have to
avoid impairing the present interest for annual exclusion purposes, but, more importantly, we
do not want to interfere with the unfettered withdrawal right necessary for §678(a)
beneficiary deemed owner status. If the settlor retains a veto power over the withdrawal
right it would negate qualification for the annual exclusion and prevent §678(a) beneficiary
deemed owner status. What if, instead, we merely include the power to accelerate the
timing of a beneficiary’s enjoyment? For example, a trust might provide that normal
settlement upon demand must be accomplished by the trustee within 30 days, but the settlor
may cause the trustee to accelerate the distribution sooner. Or, a trust may provide that the
trustee may distribute, and for 30 days the beneficiary may withdraw the contribution to the trust. The Settlor retains the power to force the trustee to accelerate the distribution, but in no way impair the beneficiary receiving the income upon request.

Normally, settlor retention of any distribution powers causes grantor trust status. Let’s borrow from techniques used in dozens of incomplete gift, nongrantor trust (ING) related PLRs. The settlor retains a non-fiduciary lifetime limited power of appointment (over gain assets, subject to a cap, as discussed throughout this paper), limited to ascertainable standards, such as health, education and support, to enable such acceleration of benefits, or better, retains unlimited powers, but exercisable only with consent of an adverse party (thus avoiding triggering §674). The latter would more clearly enable greater inclusion/step up.

Such powers do not cause grantor trust status (as confirmed in all the recent DING PLRs, pursuant to §674 exceptions), do not inhibit §678(a) beneficiary deemed owner status, do not prevent a completed gift from occurring, and yet its retention may still trigger a targeted inclusion under 2038 to the extent it is not otherwise capped. While §2038 does have an exception for powers only exercisable with adverse party consent, it is quite different from grantor trust exceptions – to get around 2038 inclusion requires that “the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property”. Thus, a limited power requiring consent from “an” adverse party, but not “all parties having an interest, vested or contingent” can successfully thread the needle and still cause estate tax inclusion without triggering grantor trust status.

234Treas. Reg. §20.2038-1(a)(2)
VI. Increased Asset Protection Opportunities Mimicking DAPTs Due to Larger Exclusion

a. *The “poor man’s DAPT”? – Using SLATs, “Power Trusts” and ILITs w/ OBIT clauses*

In addition to all of the income tax opportunities offered by the increased gift tax exclusion, ATRA also offers up greater asset protection planning opportunities. Consider this variant of a DAPT for smaller estates: Husband sets up an irrevocable trust (aka SLAT – spousal lifetime access trust) for Wife (which may be defined as whomever he is married to at the time, since we do not need to qualify for the marital deduction as an intervivos QTIP or GPOA marital trust, aka “floating spouse”). Wife has a formula testamentary GPOA, circumscribed as discussed above. Wife and children have a *lifetime* limited power of appointment to appoint to Husband/Father. Merely being a permissive appointee of a limited power of appointment should not threaten asset protection, even if the donor of the power is a permissive appointee. If wife dies first, and the GPOA is exercised successfully in favor of a trust for the husband, husband is now the beneficiary of the trust, but it is not “self-settled”, since the wife is the settlor.

Unlike intervivos QTIPs or exercises of limited powers of appointment that “relate back” to the original donor of the power, the settlor changes at Wife’s death pursuant to a GPOA (though with a lapse of the GPOA, the issue is murkier and it may only change as to 95%). This means that the trust is *not* self-settled if Husband later becomes beneficiary in a trust established by his Wife under the SLAT’s GPOA. This eliminates the main concern that people have with “SLAT” planning without a DAPT – the lack of access by a surviving spouse.

For inter-vivos SLAT (bypass) trust planning, remember the one-year rule in IRC §1014(e) discussed in Section V of this paper. As discussed in the above section, this can avoided by structuring the appointive trust differently if the donee/beneficiary spouse dies.

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235 While this is generally the common law, Ohio clarified its common law with R.C. §5805.06(B)(3)(a) – for additional CLE material on asset protection aspects of powers of appointment, email author for separate CLE outline discussing/contrasting the many advantages of “Power Trusts” over DAPTs.

236 See UTC §401, §103(15), Restatement of Trusts, 3d, §10(d), outlining that a POA can be used to establish a trust and the settlor is the person creating or contributing property to it. This is clear when a GPOA powerholder appoints to a new trust, but uncertain if a GPOA powerholder merely allows the power to lapse. Is the lapse equivalent to “contributing property” or not? As discussed herein, §2041 doesn’t even require a competent powerholder with knowledge, but state law might have a higher bar for being considered a “settlor”.

237 UTC §505(b), for Ohioans, see newly amended Ohio R.C. §5805.06(B)(3)(b) – protection is 100% in Ohio – note that for GST purposes, the 5% lapse is disregarded and the spouse with the lapsing GPOA would be considered the transferor of 100% for GST purposes – generally an optimal result. Treas. Reg. 26.2601-1(b)(1)(v)
within one year of the trust funding, but these entirely avoid the 1014(e) debate if one year passes. Realize – this comes at a cost of double use of gift tax exclusion, unless a Crummey/Cristofani type structure is used, as discussed in the above section, but even with that caveat, most couples have plenty of Applicable Exclusion Amount to soak up double use of exclusion for their highly appreciated assets – remember, ¾ of a couple’s assets are very often cash, short term bonds, IRAs, annuities, qualified plans and their home.

Of course, the power of appointment in the SLAT can be structured as a formula GPOA/LPOA as discussed in Section III of this paper, so as not to inadvertently cause any step down in basis, but this use may mean giving up some asset protection as to the LPOA appointive assets or forcing the use of a domestic self-settled asset protection trust statute such as the Ohio Legacy Trust Act.\(^{238}\) This is because, if W uses a testamentary LPOA to appoint back to a trust for H, it would not change the settlor for asset protection purposes (the “relation back” doctrine applies).\(^{239}\)

In some states, you can accomplish the same asset protection result with an inter vivos QTIP, so that less gift/estate tax exclusion is used, and it could come back to the donor-spouse.\(^{240}\) In other states, an inter vivos GPOA marital may be preferred to achieve the same asset protection result, but recall that the GPOA for a marital trust must be more open to use/abuse, and is therefore less protected from the spouse’s undesired exercise and the donee spouse’s estate’s creditors. Furthermore, inter vivos marital trusts cannot protect from 100% step downs in basis at the spouse’s death.

*Unlike DAPTs, which have to be done in certain states, use certain trustees, and have various uncertainties, requirements and drawbacks, SLATs with these kinds of provisions can be done in any state.* For a comparison chart between “Power Trusts” and DAPTs, see author’s separate outline.

Grantor trust status for such a trust after W’s death is tricky. If H establishes a trust for W and she exercises a GPOA to appoint back to a trust for H, W is now the grantor for income

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\(^{238}\) Ohio R.C. §5816.01 et seq.

\(^{239}\) Arizona may be an exception. See Ariz. Rev. Stat. 14-10505(E)(3)

\(^{240}\) See footnote 34 for a list of state statutes and further explanation.
tax purposes, overriding H as the grantor.\footnote{Treas. Reg. §1.671-2(e)(6), Example 9 – thanks to attorney Gary Maddox for correcting a typo and suggesting clarifications to this discussion.} This overrides any provisions or conclusions that would otherwise deem H the grantor under IRC §§671-679, making it a non-grantor trust.\footnote{Treas. Reg. §1.671-2(e)(5)} However, if W merely allows her GPOA to lapse at her death, and the trust then continues for H, it is unclear, perhaps for state creditor protection law as well.\footnote{Treasury could have simply added the words "lapse" or "release" of a GPOA in §1.671-2(e), as in other sections, but did not. Absent an exercise of a GPOA, it is unclear under what authority a lapse would override H as the grantor under IRC §671-679 (due to access to income, swap/substitution power, income for insurance or other administrative power). Therefore, H may still be considered the grantor of the trust for income tax purposes, since, contrary to the specific language of the regulation, W did NOT exercise her GPOA.} This may be another area where state law, estate tax and income tax law do not necessarily stride in lock step.

b. **ILITs (also see section on the Upstream Crummey Optimal Basis Increase Trust)**

ILITs should not be overlooked in considering optimizing basis clauses, and can benefit just as much as any bypass trust. This is not to achieve a step up or avoid step down in basis on the insurance policy – it’s the investment proceeds after the insurance policy pays off.

Example: John establishes an ILIT for his wife and kids – he’s young, it’s a $2 million term policy. John’s remaining estate is $1 million. Lo and behold he dies. His wife takes the $1 million in qualified plan and home outright, she has $10.68 million AEA. Jane has an estate well under this amount. Over time the ILIT investments triple in value – basis $2.5 million, FMV $6 million. With an OBIT clause, we really have the best of all worlds – if Jane’s estate increases over time beyond her AEA (or if she loses her DSEU amount through remarriage), the ILIT can shelter funds from her estate, but if her estate remains under her AEA, **$3.5 million of basis is saved** – over a million dollars of income tax saved depending on the state and brackets of the beneficiaries. And, as discussed in Section III, this should be crafted so as to avoid step downs on any loss assets and apply to the most appreciated assets first in the event the amount must be capped. Needless to say, language should coordinate with the bypass trust to be read in pari materia.

**DINGs (NINGs, OINGs and other INGs).** These are generally designed to be in the settlor’s estate at the settlor’s death, but upon death can simply be appointed to A/B trusts that have “OBIT” features. See Part VIII for more tax shifting ideas for these trusts.
VII. Use of Optimal Basis Increase Techniques by Pre-Existing Irrevocable Trusts

The concepts herein can also be applied to inter-vivos irrevocable trusts and trusts continuing for additional generations. Similar techniques can be incorporated in downstream dynastic trusts for better basis increases to grandchildren and beyond. This would involve GST considerations as well.

Most importantly, practitioners should not overlook the significant value in adapting many pre-existing irrevocable bypass trusts (including intervivos SLATs, or other irrevocable trusts) to fully use this $5.34 million (and increasing) basis increasing “coupon”. This may be done by various ways – triggering the Delaware Tax Trap using an existing limited power of appointment that permits appointment to trusts, or changing the trust via decanting or court reformation to add a limited or general power of appointment. Generally, non-judicial settlement agreements (aka private settlement agreements) are probably not ideal, since it is unclear to what extent those can make the necessary changes.\textsuperscript{244} Using LPOAs may also be preferred over GPOAs. The reasons for the latter two statements will become apparent later in this Section. Choice of these options will necessarily be trust and state law dependent.

The advantages may be significant. Imagine how many current irrevocable bypass trust surviving spouse beneficiaries have well under $5.34 million in their personal estate? (actually, a widow(er) might have quite a bit more AEA if their spouse died after 2010 and they elected DSUEA – nearly twice as much depending on the years passed, inflation).

a. Using Existing Limited Powers of Appointment to Trigger Delaware Tax Trap

Example: John died in 2008, leaving his wife Jane $2 million in non-IRA assets in a typical bypass trust, which has now grown to $3.5 million. Although some of the assets have been sold, rebalanced, the trust assets now have a basis of $2.5 million. Jane’s assets are $2.5 million. Why waste $2.75 million of her $5.34 million “coupon” she is permitted to use to increase basis step up for her family? Jane therefore amends her will/trust to exercise her limited power of appointment granted in John’s trust, mirroring language discussed above: assets with basis greater than FMV or IRD go to a trust for her children (or simply continue in

\textsuperscript{244} Ohio R.C. §5801.10(C) “The agreement may not effect a termination of the trust before the date specified for the trust's termination in the terms of the trust, change the interests of the beneficiaries in the trust***”; UTC §111 is much more vague. Of course, parties can still carve an agreement and then get a court to bless it.
trust under the residuary), and assets with basis under FMV (for which Jane and her family desire the step up) simply go to a similar trust for her children that contains a presently exercisable general power of appointment, triggering IRC §2041(a)(3) and getting the family up to an additional $1 million of basis free of charge. And, of course, this exercise can be limited to her available Applicable Exclusion Amount and applied first to the most appreciated assets first, capped to prevent any estate tax and/or account for any state estate tax, or even chosen to exploit the assets most likely to be sold by beneficiaries first, as discussed above.

Many beneficiaries do not have current asset protection issues, asset levels close to a taxable estate or any desire to spray or gift inherited assets. Thus, the vast majority of LPOA power holders and their prospective appointees would probably prefer to save income tax with a higher basis than avoid the negatives of a presently exercisable GPOA. Unless there are current creditors on the horizon, beneficiaries can always avail themselves of self-settled asset protection trust legislation in Ohio, Delaware, Alaska or one of the other jurisdictions that permit this. If there are, beneficiaries can disclaim their PEG power. So, in practical terms, the main reason to forego any use of the Delaware Tax Trap is if a powerholder wants to preserve assets for grandchildren or other beneficiaries.

b. Amending Irrevocable Trusts – Why they are Effective at the Power Holder’s Death

But let’s say Jane did not have a limited power of appointment, or doesn’t like the drawbacks of granting the beneficiaries a presently exercisable general power of appointment. Aren’t we taught after Bosch and similar cases and PLRs that trying to reform a trust for the marital or charitable deduction post-mortem (or post gift) should not be recognized? Isn’t this a similar trend for IRA “see through trust” rulings?

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245 Commissioner v. Estate of Bosch, 387 U.S. 456 (1967) held that a state trial court decision as to an underlying issue of state law should not be controlling when applied to a federal statute, that the highest court of the state is the best authority on the underlying substantive rule of state law, and if there is no decision by the highest court of a state, then the federal authority must apply what it finds to be state law after giving “proper regard” to the state trial court’s determination and to relevant rulings of other courts of the state. It does not say to ignore state law. For one of several cases denying the marital deduction for attempts at a post-mortem “fix” or relying on marital savings clauses, see Estate of Rapp, 130 F.3d 1211 (9th Cir. 1998).

246 Although taxpayers can argue that September 30 of the year after death should be the important date to “fix” a see through trust by, and I would still argue this in clean up mode, the IRS could argue that, except for disclaimers that “relate back”, the Code and Regulations require there to be a beneficiary named by the owner/employee pursuant to the terms of the plan and/or default under agreement to obtain status as a “designated beneficiary” at the time of death, and if the trust changes terms significantly after that, it is arguably not the same beneficiary post-reformation that it was at the time of death, hence no DB, even if effective for non-tax law. IRC §401(a)(9)
These cases and rulings that deny the effects of state court proceedings can easily be distinguished. Most of them concerned taxpayers trying to change the legal effect of what the trust terms were at the death of the original transferor, after the taxable event (i.e., does it qualify as a marital, charitable or see through trust at death).\(^{247}\) They do not concern what a transferee decedent owned or didn’t own at the time of a transferee’s death.

IRC § 2041 concerns what rights and powers a decedent has over property. If trust terms change so as to be legally binding, and grant greater rights to the power holder, the property rights held by the power holder must change.

In Rev. Rul. 73-142, a grantor/decedent established a trust for his wife and children, not subject to ascertainable standards, and mistakenly retained the power to remove and become the trustee.\(^{248}\) Years prior to his death, he went to court to successfully construe the trust to mean that he could not be appointed trustee (nowadays, we would also preclude removal and replacement with any related/subordinate party).\(^{249}\) The IRS ruled that this court order had tax effect to negate the IRC §2036/2038 issue *despite the state court decree being contrary to the decisions in the state’s highest court*. While this is not an IRC §2041 case, this Rev. Rul. bodes well for such proactive planning to add a limited GPOA for better tax results.

One PLR following Rev. Rul. 73-142 noted a key difference with *Bosch*: “Unlike the situation in *Bosch*, the decree in the ruling [73-142] was handed down before the time of event giving rise to the tax (that is, the date of the grantor’s death).”\(^{250}\) In that PLR, a state court order construing a tax apportionment clause to apply to the GST non-exempt marital share rather than equitably to both GST exempt and GST non-exempt shares was given effect. This was good proactive planning by counsel prior to the taxing event to keep more funds in a GST sheltered trust.

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\(^{247}\) “[N]ot even judicial reformation can operate to change the federal tax consequences of a completed transaction.” *American Nurseryman Pub. v. Comm.*, 75 T.C. 271 (1980), citing a string of cases holding similarly from various circuits.

\(^{248}\) Rev. Rul. 73-142

\(^{249}\) Treas. Reg. §20.2041-1(b)(1), Rev. Rul. 95-58

\(^{250}\) PLR 2005-43037
Like the above rulings, any such modifications to ensure an Optimal Basis Increase would similarly affect a surviving spouse’s rights before the time of his or her death, and with current trust law trends, such reformations would unlikely even be contrary to the state’s highest court. Obviously, if beneficiaries try to fashion such a solution after both parents’ deaths, this would be unavailing under Bosch and many other decisions. However, there is strong precedent that private settlement agreements, court actions pursuant to statute, decanting, trust protector or other methods to add a formula GPOA prior to the time of the event giving rise to the tax (the surviving spouse’s death), should (and must) be given effect – no different than a complete distribution/termination of the trust.

The reverse, removing a GPOA, is a more difficult issue, so any reformation should strongly consider the irrevocable nature of the tax consequence. Generally, a power holder releasing a general power of appointment would trigger gift tax, and could trigger taxation of any IRD. However, there are rulings which honor this when done through court reformations, without negative gift/estate tax consequence. In one recent PLR, the IRS allowed a post-mortem court reformation to essentially remove a GPOA without adverse tax effect. Another older IRS ruling also found that a court reformation that removed a beneficiary spouse’s testamentary GPOA would not cause a taxable gift and would be honored to avoid later estate tax inclusion.

c. Limiting Amendments to Keep Fidelity to Settlor’s Intent

Any added powers of appointment can limit appointees to certain trusts. In our example above, if Jane had not been granted a limited power of appointment, the trustee might decant to a near identical trust which grants Jane the limited testamentary power to appoint certain assets to the Jane Doe Irrevocable Delaware Tax Trapping Trust, a trust established with terms nearly identical to her husband John’s trust for the children, only granting the children a PEG power circumscribed using techniques discussed above. Indeed, this would be a more prudent exercise of the trustee’s decanting power (or court’s power to

251 IRC §2514
252 PLR 2011-32017, see also PLR 2010-06005 approving reform of a GPOA to an LPOA w/o adverse tax effect
253 PLR 9805025
amend), since it would do less harm to the original settlor’s intentions than adding a broad LPOA or GPOA (indeed, many trusts pay outright to children at some point anyway).\textsuperscript{254}

Limited amendments do much less harm to a settlor’s probable intent than a major amendment or wholesale termination, and this is reflected in the Uniform Trust Code’s slightly different standards for reformations:

“(b) A noncharitable irrevocable trust may be \textit{terminated} upon consent of all of the beneficiaries if the court concludes that \textit{continuance of the trust is not necessary to achieve any material purpose of the trust}. A noncharitable irrevocable trust may be \textit{modified} upon consent of all of the beneficiaries if the court concludes that modification \textit{is not inconsistent with} a material purpose of the trust.”\textsuperscript{255}

Of course, if we’re dealing with an intervivos irrevocable trust where the settlor is still living, the settlor’s probable intent at the time of establishing the trust may be irrelevant, this being ignored in the primary UTC reformation provision:

(a) A noncharitable irrevocable trust may be modified or terminated upon consent of the settlor and all beneficiaries, \textit{even if the modification or termination is inconsistent with a material purpose of the trust}.\textsuperscript{256}

So, in most states, the power to amend irrevocable trusts is quite broad, but we should not assume that these amendments do not have any tax effect. The next sections will explore these potential tax effects and why the form of procurement may matter, specifically, whether a beneficiary causes the amendment, or possibly even whether a beneficiary’s non-action or acquiescence causes the amendment.

d. Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment

With all the above arguments that §2041 should still apply equally to amended or reformed trusts, that is not to say that amendments may not have other effects. \textbf{Beneficiary procurement or even acquiescence to trust amendments or terminations may have detrimental tax and asset protection effects.} This is arguably one of the most under-

\textsuperscript{254} For a great summary of the more than 20 various decanting statutes and their characteristics, see http://www.sidley.com/state-decanting-statutes/
\textsuperscript{255} Uniform Trust Code §411(b)
\textsuperscript{256} Uniform Trust Code §411(a)
discussed areas of estate and asset protection planning in light of the tsunami of trust settlement agreements, amendments and reformations increasingly being used by practitioners pursuant to the Uniform Trust Code or other law.\textsuperscript{257}

Let’s start with quick reminder of the broad definition of a gift for gift tax purposes (or transfer with retained interest in the estate tax context), and then explore a few cases to eke out the meaning in the context of trust amendments. Treas. Reg. §25.2511-1:

“(c)(1) The gift tax also applies to gifts indirectly made. Thus, \textit{any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax}.”

“(g) (1) Donative intent on the part of the transferor \textit{is not an essential element} in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor. However, there are certain types of transfers to which the tax is not applicable. \textit{It is applicable only to a transfer of a beneficial interest in property}. It is not applicable to a transfer of bare legal title to a trustee. A transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee (but such a transfer may constitute a gift by the creator of the trust, if until the transfer he had the power to change the beneficiaries by amending or revoking the trust). The gift tax is not applicable to a transfer for a full and adequate consideration in money or money’s worth, or to ordinary business transactions, described in § 25.2512-8. 

(2) \textit{If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard} which is set forth in the trust instrument.

Further, Treas. Reg. §25.2511-2(a) provides that:

“The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is \textit{measured by the value of the property passing from the donor}, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

If the act of transfer is involuntary, then arguably no taxable gift occurs. However, the lines are blurred considerably in the event a putative donor could have prevented a transfer –

\textsuperscript{257} This is not to blame the Uniform Trust Code – many such options were probably available under common law before anyway, or in non-UTC states, but the UTC undoubtedly creates clarification, interest and awareness.
a failure to preserve or defend one's rights by inaction may be considered a transfer. To take an extreme example - if my son steals my car, without my knowledge or consent, including title, and I fail to correct or bring suit, I have clearly made a gift. Other cases are not so easy, especially when it's unclear whether someone can prevent an amendment (transfer).

The Sexton case is instructive here. Sexton involved an irrevocable trust established by a father for his seven children. The trust was due to terminate twenty years after the father's death, but could be amended by a majority of the trustees with consent of 2/3 of the beneficiaries. The beneficiaries consented to extend the trust past the original termination date. One beneficiary, Bertha, died after the original termination date but before the amended termination date. The IRS argued that the amendment was ineffective, but if not ineffective, still constituted a transfer subject to IRC §2036. The district court held, and 7th Circuit confirmed, that the amendment was effective pursuant to the trust and state law, but that her complicity in this amendment made her a de facto transferor for §2036 purposes. Since she had a right to funds at the original termination date, her acquiescence was a relinquishment of that right, which may be considered a transfer of property for estate/gift tax purposes. Importantly, the court noted that, had the beneficiary not consented, their argument that the amendment was not a relinquishment/transfer and therefore had no tax effect "might be persuasive" – but the beneficiary's active consent killed her estate's case, even though the amendment could have been accomplished without her consent. Another way to look at this case (not discussed in the opinion) is to see each beneficiary as exercising a GPOA (although other parties' consent was required, they may have been non-adverse parties). Of course, the family in Sexton was trying to avoid inclusion – what if, as posited herein, inclusion is the goal? Not all transfers with retained interest are evil.

There was a district court case that held to the contrary on similar facts (though the issue was whether the extending amendment created a grantor trust rather than an estate/gift tax case). The Brooks court found that exercising such powers (analogizing to

258 Rev. Rul. 81-264, also GCM 38584
259 Sexton v. U.S., 300 F.2d 490 (7th Cir. 1962), cert denied 371 U.S. 820 (1962)
limited powers of appointment) granted by the trust were not transfers of property. This
district court case reasoning was rejected by the 7th Circuit in Sexton, but it also lays out the
contrary argument that might be cited in “clean up mode”, and may be a useful citation when
amending trusts to gain better ongoing income tax results as discussed in Part VIII.

Another recent PLR highlights the gift tax issue: a mother was the current beneficiary
(and co-trustee) of a trust and entitled to income and principal only at the trustee’s discretion
for HEMS. She did not need nor want any discretionary distributions, had never taken any,
and never expected to. Her children were remaindermen. Mother, children and trustees
petitioned local court for an early distribution to the children, which would be allowed with
consent, as long as it did not frustrate the settlor’s material purpose of the trust. The IRS held
favorably on GST and income tax results, but held that, although the gift may be “nominal”,
there is still a taxable gift by the mother for giving up her rights, however speculative in
value.261 The IRS offered no guidance as to how to value such a discretionary interest.

The lesson: procurement or even active acquiescence to creating a GPOA or even LPOA
that could divest a beneficiary of a property right could be a transfer and taxable gift, but the
value of such gift in many cases would be minimal, since it is based on the “value conferred
upon another” at the time.262 Outright terminations are obvious: if mom were lifetime
beneficiary of a bypass trust and mom, kids, grandkids agree to terminate the trust and
distribute assets to mom, the remaindersmen have very likely made a taxable gift. Even if
parties could care less about gift tax, it is unclear whether §1014(e) may deny the step up (but
permit the step down) in basis if mom dies within one year, since it is likely the assets would
come back to the children (less obvious, as to how much).

Adding GPOAs is much less clear, but probably does not have the same implication as a
termination. E.g., mom is lifetime beneficiary of bypass trust, remainder to son. Mom and
son agree and pursuant to state law procure a reformation to grant mom a testamentary
GPOA. As stated in discussions of authority cited above, the IRS should have to honor this
change in property rights at mom’s death if pursuant to state law. However, could son be said
to have made a gift by converting his vested remainder interest into a vested remainder

261 PLR 2011-22007, see also similar PLR 8535020
262 Treas. Reg. §25.2511-1(c)(1) quoted in full above
interest now subject to divestment? Could this trigger §1014(e) if done within one year of mom’s death? Unlike our previous trust termination example, no value clearly transferred to mom – or, at the very least it’s much more minimal. This probably makes more than a few readers’ heads spin. Here’s the nutshell – it is safer to avoid this morass of issues through amending actions initiated by an independent trustee or trust protector only, or, by an interested party who could not be said to be making a gift by initiating the action.\textsuperscript{263}

e. Asset Protection Effect of Beneficiary Procurement or Acquiescence to Amendment

It is only a matter of time before such arguments are used by creditors and bankruptcy trustees to attack any trusts amended in such manner as self-settled trusts.\textsuperscript{264} There are cases that bust such amended trusts when there is no clear amendment power in the trust or state law, but I would caution that such cases might be extended even to cases in which a debtor/beneficiary takes other actions to extend a trust pursuant to state law.\textsuperscript{265}

If the court order is retroactive \textit{nunc pro tunc}, as a trust \textit{construction} might be, there is a good argument that the debtor should be absolved from any fraudulent transfer claims similar to the relation back doctrine governing such rules for disclaimers in most states.\textsuperscript{266} However, it is wisest to avoid the argument altogether through an action initiated by a trustee (or a trust protector) other than the beneficiary, whether through court reformation or decanting.

f. Amendments or Modifications Affecting GST Exemption

Could any amendments/modifications affect GST exemption? Not under most circumstances, but this is yet one more issue to examine when modifying irrevocable trusts.

OTHER CHANGES.
(1) A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is

\textsuperscript{263} See Gifts by Fiduciaries by Tax Options and Elections, cited and discussed on page 24, footnote 56. But, recall the beneficiary spouse as trustee initiated the reformation in PLR 9805025 and PLR 2011-32017 to no ill effect.
\textsuperscript{264} For discussion of fraudulent transfer issues using decanting see Ferri v. Powell-Ferri: Asset Protection Issues, Perils and Opportunities with Decanting, Ed Morrow & Steve Oshins, LISI Asset Protection Newsletter #240
\textsuperscript{265} Hawley v. Simpson (In re Hawley), 2004 Bankr. LEXIS 173 – finding that an extension of trust by beneficiaries created a self-settled trust, negating 11 USC §541(c)(2)’s ordinary protection/exclusion of third party spendthrift trusts, making it accessible to the beneficiary’s bankruptcy estate. For more on busting third party trusts, how such actions might trigger fraudulent transfers and asset protection, see author’s separate asset protection CLE outlines.
\textsuperscript{266} See discussion in the Uniform Disclaimer of Property Interests Act, §§6-7
valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.\(^{267}\)

Thus, practitioners should take care not to cause any exempt trust to be modified or terminated in such a way to shift a beneficiary interest to a lower generation.

g. **Substantial amendments causing a taxable exchange under Cottage Savings, §1001**

In a rare and extreme case, settlements and amendments of trusts can cause an income taxable exchange pursuant to IRC §1001. The seminal oft-cited case for this proposition is *Cottage Savings Assn v. Commr.*\(^{268}\) In that case, the taxpayer, a savings and loan, had exchanged one group of mortgages for another set of mortgages. The exchanged mortgages were substantially identical in many respects. Nevertheless, the court determined that the exchanged mortgages were of legally distinct entitlements because of the material difference in the obligors and security and the legal entitlements pertaining thereto. Therefore, the taxpayer was determined to have disposed of its interests in the exchanged mortgages and could recognize the loss, for income tax purposes.

Prior to *Cottage Savings*, in *Evans v. Commissioner*, the taxpayer gave her income interest in a trust to her husband, who agreed to pay her a fixed lifetime annuity. The tax court concluded that this was also a taxable realization event (this was prior to enactment of IRC §1042 that now generally disregards sales between spouses).\(^{269}\)

By contrast, where a taxpayer exchanged her interest in a trust for a right to similar specified annual payments from the remainderman of the trust, the 7th Circuit held that the taxpayer did not “dispose” of her trust interest, since the taxpayer *was to receive the exact same annual payments* from the remainderman as she had been receiving from the trust, which the 7th Circuit found to be a distinguishing factor from *Evans*. The fact that the trust


\(^{269}\) *Evans v. Commissioner*, 30 T.C. 798 (1958)
and fiduciary relationship was removed altogether was not “meaningful” – there was no “change in economic position” necessary for a sale or disposition.\textsuperscript{270}

The IRS applied the \textit{Evans} and \textit{Cottage Savings} rationale against a proposed trust settlement and modification in PLR 2002-31011.\textsuperscript{271} The trustee and the beneficiaries (one of whom was the taxpayer in the PLR) had agreed that the taxpayer would, in exchange for the income interest he held in the trust, receive (i) a 7% annual unitrust payment from the trust, (ii) principal from the trust in the discretion of the trustee and (iii) \textit{a testamentary general power of appointment over the remaining trust property}. Charitable remaindermen would receive an immediate payment based on the value of their remainder interest and be thereafter removed. The IRS ruled that the transaction was in effect a sale or disposition under IRC §1001(a).\textsuperscript{272} It’s worth reading the IRS reasoning as to why this triggered gain to avoid the disastrous result for other settlements:

“Grandson currently is entitled to trust income, subject to a floor and a ceiling. Under the proposed order, he would become entitled to annual payments of seven percent of the fair market value of the trust property, with the trustee having some discretion to make additional payments under certain circumstances. Even assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required by the Performance Chart. He also would not be limited by the Performance Chart’s maximum annual payment ceilings. Finally, payments would be determined without regard to trust income. In short, Grandson’s interest in the modified trust would entail legal entitlements different from those he currently possesses. \textit{This conclusion is reinforced by adding to the Taxpayer’s current entitlement the general power of appointment over any trust corpus}, even though this was a necessary element in a favorable GST conclusion set forth in issue #3, below.”

Unlike in \textit{Cottage Savings}, the taxpayer in the PLR was required to disregard his basis in the interests being exchanged because of their term nature, as provided in IRC §1001(e). Accordingly, the taxpayer was required to recognize capital gain \textit{on the entire amount received}. Yikes! If you knew only of this PLR, you may be wary of doing \textit{any} modifications to irrevocable trusts.

\textsuperscript{270} \textit{Silverstein v. United States}, 419 F.2d 999 (7th Cir. 1969)
\textsuperscript{271} PLR 2002-31011
\textsuperscript{272} IRC §1001(a), Treas. Reg. §1.1001-1(a)
Thankfully, this PLR is more a fluke than a trend, and unitrust conversions and powers to adjust were subsequently granted some safe harbor regulations under §643. Let’s differentiate this ruling from the dozens of others subsequent to it that are more taxpayer friendly which held that various modifications, mergers, amendments and reformations did NOT trigger §1001 or Cottage Savings.273

Because I’m way too lazy to analyze dozens of these PLRs (many of which are simple divisions of trusts with no additional changes), let’s pick three recent PLRs. In PLR 2010-42004, two trusts were merged, and after the modification, a withdrawal right became exercisable only during the month of January of each year, rather than at any time during the year.274 Despite this change, the IRS found that “no beneficiaries are acquiring new or additional interests in surviving Trust E as a result of the merger of Trust B into Trust E. Moreover, there does not appear to be any reciprocal exchange of legal rights and entitlements involving Child 2 or any of the other beneficiaries under the trusts here. Therefore, no "exchange" has occurred under § 1001.”

There are really two key questions that emerge from PLR 2002-31011 and Cottage Savings when amending irrevocable trusts – 1) when do you even have a “sale or exchange” pursuant to IRC §1001 and 2) if so, when would the changes be “material” differences in legal entitlement?

Is there a “sale or exchange” in most reformations? In PLR 2002-31011, there was a dispute and legal settlement by which the parties were actively exchanging substantial interests – the charities were giving up their trust expectancy for immediate payout and the grandson was getting a high unitrust and greater testamentary powers in lieu of an income payout. Evans involved an exchange of a trust income interest for an annuity outside of trust. With any quid pro quo there is arguably an exchange. But with a decanting or certain court reformations that do not even need the consent of the beneficiary,275 the beneficiary would

274 PLR 2010-42004
275 E.g. UTC §411-§417
not be exchanging anything, nor would the trustee – there is no quid pro quo as in the 2002 PLR and certainly nothing like the obvious exchange in *Cottage Savings*.

Treasury recognizes this for trustee severances of trusts:

**(h) Severances of trusts**

**(1) In general.** The severance of a trust (including without limitation a severance that meets the requirements of § 26.2642-6 or of §26.2654-1(b) of this chapter) is not an exchange of property for other property differing materially either in kind or in extent if—

**(i) An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and**

**(ii) Any non-pro rata funding** of the separate trusts resulting from the severance (including non-pro rata funding as described in§26.2642-6(d)(4) or § 26.2654-1(b)(1)(i)(C) of this chapter), whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.²⁷⁶

There is no clear definition of “severance” above, but decantings and unilateral constructions/reformations/divisions of trusts initiated by the trustee seem to fit a “severance” more than a “sale or disposition” – and these would of course be done pursuant to the trust and/or state law and any good trust would permit non-pro rata funding.²⁷⁷ In most instances, typical amendments are more reasonably described as a severance and/or more squarely fit with the 7th Circuit’s conclusion in *Silverstein* – if the beneficiary is keeping the same payment scheme as before, with no change in economic position, it’s hard to argue there is a sale or exchange. By contrast, contested settlements, or reformation actions initiated or negotiated by beneficiaries, particularly if a termination is involved, may come closer to resembling a sale, as in PLR 2002-31011 or *Evans*.

Moreover, even if there were a deemed exchange, most changes would not be nearly as material as in PLR 2002-31011. Still, this PLR serves as a warning to make changes as minimal as possible, and to use a method that does not require active beneficiary procurement if possible, to avoid any “sale or exchange” argument altogether. Who knows what the IRS or tax court will find to be “material”? What should we make of the statement in

²⁷⁶ Treas. Reg. §1.1001-1(h)
²⁷⁷ If you are in a UTC state, see Uniform Trust Code §816(22), which adds that power. Comments expressly note why: “Paragraph (22) authorizes a trustee to make non-pro-rata distributions and allocate particular assets in proportionate or disproportionate shares. This power provides needed flexibility and lessens the risk that a non-pro-rata distribution will be treated as a taxable sale.”
PLR 2002-31011 that the adding of a general power of appointment to the trust “reinforced” the conclusion that there was an exchange? Would it have been enough by itself?

If the amendment merely granted a general testamentary power to appoint to creditors with consent of a non-adverse party would it be materially different? If the amendment merely granted a limited power of appointment that only permitted the appointment to the same remaindermen or to trust therefore, in order to trigger the Delaware Tax Trap as discussed in Part III, would such a minimal change in the current interest be “material”?

In PLR 9352005, the beneficiary exercised a lifetime limited power of appointment to modify trust provisions concerning the naming of trustees, and remove his lifetime limited power of appointment in the new trust. The IRS ruled that §1001 did not apply, that the removal of a power of appointment did not affect beneficial ownership, and moreover, naturally questioned whether it could even be a transfer in the first place:

“Taxpayer and Son will be entitled to the same benefits under the new trust as they were entitled to under the 1978 trust. Son will not possess a power of appointment over the assets in the new trust. However, the exercise of the limited power with respect to the 1978 trust and the lack of a power of appointment over the new trust in this case will not materially affect either Taxpayer or Son’s beneficial interest in the property that comprises the trust principal. Here, the rights of Taxpayer and Son as to principal and income are exactly the same under both trusts. As in Silverstein, previously cited, the substance of the transaction is that the beneficial interests of the parties will not change; they will be as secure as they were before, neither will realize a realistically different value under the new trust than they had under the 1978 trust, and neither will give anything meaningful in the transaction. The transfer, if it is a transfer at all, is a transfer of bare legal title to the trust assets not affecting the beneficial ownership of the property.”

In PLR 2013-20004, the IRS was quite lenient and ruled that such a trust modification that removed the requirement to pay “all net income” to the beneficiary was not a taxable gift, did not trigger gain, nor did it affect the GST zero inclusion ratio. I believe the giving up of net income was not considered a taxable gift in the PLR because any accumulated

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278 PLR 9352005
279 PLR 2013-20004, modifications complying with GST grandfathering regs were OK for allocated GST exempt
income, pursuant to the trust amendment, was payable to and would be included in the
beneficiary’s estate.

There are no clear answers, but the weight of the PLRs (which, of course, are not
precedent), but more importantly the code, regulations and holdings in the Cottages Savings
and Silverstein cases, do not seem to go so far as to implicate relatively minor amendments
that do substantially affect what a beneficiary is currently receiving. To analogize, there is no
hint in the Cottage Savings case that a mere minor modification of one of the taxpayer’s loans
would have triggered tax – the case concerned swapping a book of loans with completely
different obligors and properties as security interests!

Most common amendments contemplated by this paper should not be “sales or
exchanges” - they are not negotiated between parties nor do they involve “consideration” in
the contractual sense as in Cottage Savings and PLR 2002-31011. Even if it were a disposition,
it is certainly arguable, as the IRS found in PLR 9352005, that changes such as contemplated
by this paper should not be material – especially if it’s only adding a limited rather than
general power of appointment, or simply adding language to allow capital gains to be part of
DNI. That said, practitioners should take care to avoid a negotiated quid pro quo between
beneficiaries and a complete overhaul (and partial termination) of a trust as in PLR 2002-
31011.

h. Decanting with more common “HEMS standard” trusts without absolute discretion

There is an understandable misconception that decanting can only be accomplished
with trusts having absolute discretion. However, many states have a “dual track” mode of
decanting, one level of decanting that is applicable to trusts with wide discretion, and a more
limited level available to those trusts without wide discretion. Ohio is illustrative: Ohio R.C.
§5808.18 lays out two levels of decanting in paragraphs A (absolute discretion) and paragraph
B (less than absolute discretion). The former is well known, similar to many other states and
even is meant to codify Ohio common law.
The latter is a more difficult case, but such trusts are *much more common*. Why? Because many couples wanted to name their spouse as both beneficiary and trustee or co-trustee, so there is commonly a HEMS standard in Bypass Trusts.

Paragraph B of Ohio’s decanting statute still permits “distributing all or any part of the principal subject to the power, and all or any part of any income that is not otherwise currently required to be distributed, to the trustee of a second trust.”, but there is the additional requirement that “The exercise of a trustee's power under this division is valid only if the governing instrument for the second trust does not materially change the interests of the beneficiaries of the first trust.”

This of course begs the question whether the narrowly crafted changes anticipated by this paper would *materially* change the interests of the beneficiaries of the original trust. How do you define *material*? If time permits you could get the local probate court to approve it.

Of course, if you go to probate court, most states provide much clearer avenues for the trustee to accomplish a court reformation to achieve the exact same result, without the uncertainty that a “non-absolute discretion” decanting entails, so any court petition might ask for alternative remedies: approve the decanting, but if you can’t approve the decanting, reform the trust.280 The drawbacks to court petitions vary state to state, but are essentially the same as for any court process – is there much cost/delay? Will there be difficulty getting all the necessary beneficiaries served and possibly guardians appointed for minor children or incompetent beneficiaries if there is no clear virtual representation? Might someone object at a hearing? Decanting avoids many of these issues, if it’s clear, but a court order would lead to a much more certain result when there is not absolute discretion to decant.

i. Why legitimate modifications are superior to “self-help” terminations

Speaking around the country on this topic, one hears plenty of anecdotal evidence of families with individual trustees simply terminating AB trusts where there is no estate tax

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280 Uniform Trust Code §§411-418. E.g. Ohio R.C. §5804.16 *Modification to achieve settlor’s tax objectives*

“To achieve the settlor's tax objectives, the court may modify the terms of a trust in a manner that is not contrary to the settlor's probable intention. The court may provide that the modification has retroactive effect.” Similarly, for those non-UTC states, see the Restatement (Third) of Property: Wills and Other Donative Transfers § 12.2:

“A donative document may be modified, in a manner that does not violate the donor’s probable intention, to achieve the donor’s tax objectives”
concern – the question being, “so what if we just terminate the trust without all your expensive lawyering?” Despite all the asset protection concerns, and remote concerns of grandchildren suing their parents, etc., this may not lead to the estate inclusion/step up that families believe they would achieve, since it may be void.281

Let’s explore a common example of this and how a savvy IRS agent or tax court may attack it. Mom is a widow and beneficiary of a bypass trust of $2 million (probably trustee or co-trustee as well). Her other assets are well under $1 million and there are no plans to move to a state with an estate tax. Mom and her children agree to simply terminate the trust by distributing all the assets to her (perhaps some to the kids too), despite ascertainable standards limiting her distributions to health and support needs only, and she does so.

This drastic change is much more like the Cottage Savings and Evans cases, and PLR 2002-31011 discussed in section g above, and is certainly not anywhere close to being a severance pursuant to the trust instrument or state law, as exempted in the safe harbor of Treas. Reg. §1.1001-1(h). So, it’s altogether possible (and more likely than amendments), that the family just triggered income tax on all the assets pursuant to IRC §1001, overriding the general rules of Subchapter J, which would not usually trigger any gain upon a valid terminating distribution. This might not only involve long-term capital gains, but if part of the trust included non-Roth retirement plans payable to the trust, would a deemed “sale” trigger the inherent ordinary income on those accounts (and/or kill the tax status because it is partially a taxable gift of the interest)? Even if you argue that a portion is a gift from the children, rather than a “sale or exchange”, this does not necessarily get around a taxable event for the larger remaining portion. These results would be a disaster, and this possibility is overlooked in articles in the popular press about “killing the bypass trust”. Would the IRS ever argue something so extreme and seemingly unfair? Review PLR 2002-3101

Could the IRS claim that the title to the assets never legally passed to mom, therefore the assets traceable to the bypass trust are not in her estate, therefore not even entitled to a step up in basis? Unlike Rev. Rul. 73-142 and other authority discussed previously, this “self-

281 E.g. N.Y. Estates Powers and Trusts Law § 7-2.4. Act of trustee in contravention of trust. If the trust is expressed in the instrument creating the estate of the trustee, every sale, conveyance or other act of the trustee in contravention of the trust, except as authorized by this article and by any other provision of law, is void.
help” trust termination is not pursuant to state law or the document, thus encouraging the IRS to simply ignore it for tax purposes (meaning, of course, no step up in basis). Any post-mortem attempt by the family to ratify the action would likely be ignored for tax purposes.282 Following state law is much more certain to achieve the estate inclusion and step up in basis that families seek. If mom and children already consent, as noted above, this would likely involve getting consent of grandchildren (the likely contingent remaindermen), which may involve a guardian of the estate or guardian ad litem, or virtual representation.283

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283 See Uniform Trust Code §§301-305 for when parties may bind minor/incapacitated or unborn beneficiaries
VIII. The Income Tax Efficiency Trust – Ongoing Trust Income Tax Planning Techniques

As mentioned in Part I, there is 2nd major income tax issue after ATRA other than basis that may now dissuade the average couple from using ongoing trusts for planning. With the new tax regime, unless we plan, administer and invest carefully, the overall income tax to the surviving spouse and family will be higher *every year*, sometimes by a considerable amount.

Creative use of IRC §643, §678(a) and/or §642(c) provisions can ensure that capital gains are not trapped in trust at the highest rates, may get better tax treatment for special assets, and may even be sprayed to beneficiaries or charities in much lower (or even 0%) brackets. The first flowchart below outlines the ongoing tax effect of the traditional AB trust structure and the second flowchart envisions more efficient variations that will be discussed.

The above refers to trust tax rates on income exceeding $12,150 in 2014 (this number is adjusted for inflation). Certain income such as qualified plan or IRA distributions may be subject to a lower top rate because it is exempt from the 3.8% Medicare surtax. Higher long-term capital gains rates on depreciation recapture and collectibles are also ignored. “QD” refers to qualified dividend rate. The trapping of taxable income at trust rates might be exacerbated further depending on state income taxation of trusts as well.
a. **Changes to Trust Income Taxation Wrought by ATRA and the ACA**

First, let’s pause for a refresher on how the new tax regime, including the Medicare surtax, affects non-grantor trusts and beneficiaries, and why 2013 changes the game.

For individuals, the 3.8% tax will apply in 2013 to the lesser of net investment income or the excess of a taxpayer’s modified adjusted gross income (MAGI) over:

- $125,000 (married filing separately)
- $250,000 (married filing jointly and qualifying widower)
- $200,000 (single) (individual thresholds in IRC §1411(b))

The “modified” applies to those who live abroad and use the foreign earned income exclusion – for 99% of taxpayers, this is the same as adjusted gross income (AGI), the bottom line of Form 1040.

For estates and trusts, it applies to the lesser of the undistributed net investment income or the excess of an estate/trust’s adjusted (not modified) gross income (AGI) over:

- $11,950 (top tax bracket, adjusted for inflation) (IRC §1411(a)(2))

“Net investment income” is
“A (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in paragraph (2),
(ii) other gross income derived from a trade or business described in paragraph (2), and
(iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in paragraph (2),

[Minus,]

(B) the deductions allowed by this subtitle which are properly allocable to such gross income or net gain.”284

Qualified retirement income is excluded, as well as wages, self-employment income, active business income or gain from a sale of such a business.285

There are many basic ways of restructuring finances and investments to avoid the surtax, most of which also avoid/defer income tax, such as:

- using tax exempt investments such as municipal bonds;
- using investments or accounts with tax deferral features such as life insurance, deferred annuity contracts, deferred comp or retirement plans;
- utilizing traditional techniques to defer recognition/timing of gains, such as tax-free exchanges, installment sales or charitable remainder trusts;
- investing in assets with tax depreciation features, such as traditional real estate or oil and gas investments;
- more sensitive attention to tax recognition, such as using low turnover funds, ETFs and/or managing individual stocks and bonds;
- accelerating the timing of income recognition into 2012, via Roth IRA conversions, distributing C Corporation dividends or harvesting long-term capital gains;
- for decedent’s estate/qualifying trusts, electing fiscal years ending/beginning in November, 2012 (the tax applies to years beginning after Dec 31, 2012, so a Dec 1, 2012-Nov 31, 2013 fiscal year allows eleven months of 2013 income to avoid surtax).

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284 IRC § 1411(c)(1)
285 IRC §1411(c)(2),(4),(5),(6)
Most of these techniques are not new to the surtax and have traditionally been used for basic income tax planning. While some are effective planning for any year, overuse can simply become the “tax tail wagging the investment dog”.

This outline will discuss more unique opportunities and pitfalls of this new surtax and higher tax rates as applied to ongoing non-charitable, non-grantor trusts, through more proactive trust drafting, planning and administration. Without such planning, many trusts will get stuck paying a tax that might be easily avoided (or reduced). First, we’ll set forth a typical example of the basic problem, then explore potential solutions to avoid the higher taxes.

The first example below assumes that all trust/beneficiary income is otherwise subject to surtax pursuant to IRC §1411(c) (i.e., interest, dividends, capital gains, annuities, rents, royalties, passive activity income, not retirement income, municipal bond interest, active business income, sale of active business or other exception) and any capital gains is not within a special tax rate category (such as depreciation recapture or 28% rate for collectibles). The $100/$300 personal exemption and other common deductible expenses are ignored for simplicity, as well as any state income taxes.

CONSIDER: Barbara, recently widowed, is the primary beneficiary of a $2 million bypass trust established by her late husband. Her income outside the trust is $70,000. For 2013, the trust has ordinary income of $40,000 (which I have assumed to be also equal to the trust’s accounting income and distributable net income (DNI)), short-term capital gains of $30,000, and long-term capital gains of $70,000. The trustee allocates all capital gains to trust principal. In its discretion, the trustee distributes to Barbara all of the accounting income ($40,000) as well as a discretionary distribution of principal of $75,000 needed for her support. The trust is entitled to a distribution deduction of only $40,000 and has taxable income of $100,000 (the sum of its short-term and long-term capital gains).

286 It does not apply to fully charitable trusts or charitable remainder trusts – see page 135 of the Congressional Joint Committee on Taxation Report JCX-18-10, IRC §1411(e), Treas. Prop. Reg. §1.1411-3(b). This article will skip discussion of the surtax and higher rates as applied to estates, because it will often be less of a problem, due to recent step up in basis, higher than usual deductions such as attorney, executor and probate fees, and the fact that terminating estates pass out capital gains as part of DNI – but estates taking over a year to settle or pouring over into a trust will involve the same issues.

287 See IRC §1(h) for special capital gains tax rates, IRC §408(m) for definition of collectibles. For an outstanding article on the 3.8% surtax applied to businesses owned by trusts/estates, see 20 Questions (and Answers!) on the New 3.8% Surtax, by Richard L. Dees, Tax Notes, August 2013
The $75,000 principal distribution is not ordinarily included as part of what is called the “DNI deduction.” It is this latter aspect of trust income taxation that is often overlooked and misunderstood by practitioners, and is potentially the source and trap for higher tax. Once the trust is over $11,950 of taxable income (roughly $88,050 in this case), it is taxed at 39.6% (20% if LTCG/qualified dividends), plus, unless it meets an exception such as IRA or qualified plan distributions, it is also subject to the 3.8% surtax.

Back to our example and the new effect of the higher rates and the surtax: beginning in 2013, all of that short term capital gains (after $11,950) is subject to top income tax rate (39.6%), plus the 3.8% surtax. All of the long-term capital gains is subject to a top long-term capital gains tax rate of 20%, plus the 3.8% surtax. Can we work some trust accounting alchemy allow capital gains to escape being trapped in the trust? In our example, this may allow investment income to completely avoid the surtax and lower taxes on short-term and long-term capital gains as well. This would subject the short-term gains to a mere 25% or 28% tax in the hands of the beneficiary (the lower rate would apply if Barbara is a qualifying widower or remarried), instead of 43.4% (39.6% +3.8% surtax), and subject the long-term gains to a mere 15% in the hands of the beneficiary instead of 23.8% (20% +3.8% surtax).

Potential tax saving in this example if no capital gains is trapped in trust (assuming remarriage or qualifying widow filing status, if not, savings slightly less):

\[
23.8\%-15\% \times (8.8\%) \times \text{total LTCG ($70,000)} = \$6,160
\]

(amount of overall LTCG and surtax savings by taxing to beneficiary not trust)

\[
\text{plus}
\]

\[
43.4\%-28\% \times (15.4\%) \times \text{STCG ($30,000 -$11,950)} = \$2,780
\]

(amount of STCG and surtax savings from taxing to beneficiary, not trust)

\[
\text{(for simplicity, we'll assume the first $11,950 taxed to the trust would generate approximately the same tax if taxed to the beneficiary)}
\]

Total Potential Tax Savings, Annually = \$8,940

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288 IRC §643(a)(3), Treas. Reg. §1.643(a)-3(a)
289 For rules on how the surtax applies subchapter J principals to trusts, see Treas. Prop. Reg. §1.1411-3, which can be found online at http://www.gpo.gov/fdsys/pkg/FR-2012-12-05/pdf/2012-29238.pdf
If a beneficiary is otherwise in the highest tax bracket ($400,000/yr single, $450,000 MFJ taxable income, adjusted annually for inflation), then the fact that income is “trapped” in a bypass-marital trust in 2013 at the highest bracket, plus a 3.8% tax makes no difference - she would have paid that same level of tax anyway.\textsuperscript{290} Whether income is taxed to the trust or to such a beneficiary would usually be income tax rate and Medicare surtax-neutral. Most trust beneficiaries will not fit in this elite bracket of taxable income, however. And, even high-bracket taxpayers may have capital loss carry forwards that could soak up distributed capital gains.

But if distribution standards would otherwise require or permit significant distributions from principal to be made to the beneficiary, then why not arrange the accounting of those same distributions in the most tax-effective manner?

Some family situations, such as second marriages where a settlor wants the maximum proscription on the spouse’s distributions and maximum remainder for beneficiaries, do not offer much in the way of flexibility. We are mostly left with standard income tax deferral techniques. But for many families, there are good options to avoid this fate of higher ongoing trust taxation, especially if we are in drafting mode or have not yet established any history of trust accounting and administration.

There are two main methods – 1) using IRC § 678(a) to allow the spouse to withdraw all or most net taxable income, specifically including all net capital gains or, usually better, 2) coming within one of the three exceptions in Treas. Reg. §1.643(a)-3(b) which allow discretionary distributions to carry out net capital gains.\textsuperscript{291}

\textsuperscript{290} As to state income tax, trusts may pay tax in multiple states, or avoid all state income tax, depending on the circumstance – see Section VIII.n. on Incomplete Gift Non-Grantor Trusts, which discusses state trust income tax.

\textsuperscript{291} Another less desirable method to pass out capital gains to beneficiaries is for the trust to invest in an entity taxed as a partnership. Cash distributed from an entity such as a partnership/LLC and paid to the trust is generally trust accounting income, even if the cash is derived from capital gains - Uniform Principal and Income Act, §401(b). Thus, because they are “properly allocated to income” pursuant to Treas. Reg. §1.643(a)-3(b)(1), they may be included in the DNI deduction and pass out to beneficiaries on the K-1 as any other income. This, of course, does not help if there are “phantom gains” or cash distributions are not sufficiently made from the partnership to the trust. To structure an entire portfolio in this manner is highly unwieldy. Assuming the other partner can be found and the fiduciary duties worked out, there would still be issues under IRC §2519 if it were a QTIP trust, and one can imagine other practical problems in managing a large portion of the trust in this manner – not to mention the additional tax reporting.
b. IRC §678(a) and the “Beneficiary Income-Controlled Grantor Trust”

A trust that merely directs all net income be paid, or even pays all taxable income, to a beneficiary, is NOT triggering §678 – such trusts must report under the 1041/K-1 Subchapter J tax regime.\(^{292}\) To be taxable directly to the beneficiary, and reported directly on the beneficiary’s Form 1040, the beneficiary must have an unfettered right to withdraw the taxable income in question (not limited to an ascertainable standard, or with required consent of another party). This paper will refer to such trusts as “Mallinckrodt trusts”, or simply, “§678(a) trusts”.\(^{293}\) Let’s first walk through how IRC §678(a) works, then distinguish such trusts from a related but different variant, the “beneficiary defective inheritor’s trust (BDITs)”, and then explore some of the possibilities and limitations of such structures.

IRC §678(a) requires that a beneficiary be considered the owner of any portion of a trust when a beneficiary has the power to withdraw income:

a) General rule

A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

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

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

Many practitioners mistakenly interpret §678 without the “or” in §678(a)(1), as if it only applies when the beneficiary has (or had) the right to withdraw the entire principal (corpus) of the trust.\(^{294}\) This is a commonly accepted myth, but understandable, since there

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\(^{292}\) In Subchapter J, Subparts A-D, IRC §641-669, control most traditional trust tax accounting, Subpart E is the grantor trust rules, §671-679.

\(^{293}\) Mallinckrodt Trust is a term named after the seminal case of Mallinckrodt v. Nunan, 146 F.2d 1 (8th Cir. 1945), which Congress basically codified in IRC §678 in 1954.

\(^{294}\) This is probably due to, but not the fault of, recent popular articles about “beneficiary defective inheritor’s trust” (BDIT) techniques, which attempt to use third party created trusts with Crummey withdrawal rights and lapses to create irrevocable trusts post-lapse that are taxed for income tax purposes to the current beneficiary, even if the beneficiary has no current withdrawal right. Their use is limited because of the $5,000/5% lapse limitation of IRC §2041, but they are a creative use. Those techniques hinge on using §678(a)(2), in conjunction with §678(a)(1). This article focuses on a different but related variant of this concept, where the beneficiary has a current withdrawal right over taxable income. For great “BDIT” material, see Gift From Above: Estate Planning On a Higher Plane, Trusts and Estates, November 2011, by Richard A. Oshins, Lawrence Brody, Jerome M. Hesch & Susan P. Rounds; The BDIT: A Powerful Wealth Planning Strategy When Properly Designed and
have been extremely few reported cases or rulings on trust structures that only allow withdrawal powers over income and treatises have very little if any discussion of this potential variation, for the logical reason that practitioners don’t normally draft trusts this way. Yet. **But there is no reason to ignore the “or” in the statute and no requirement under §678 that a beneficiary/powerholder have any power over corpus whatsoever.** In fact, the seminal case that the statute itself was based on had no beneficiary right to withdraw underlying principal.

For instance, a trust may provide that the primary beneficiary has the unfettered right to withdraw all net income. Unless defined otherwise in the trust, this means the beneficiary is taxed only on fiduciary accounting income (dividends, interest, rents), but not necessarily all taxable income. For instance, a traditional IRA distribution might be 100% taxable income, but only 10% accounting income, and capital gains would not usually be accounting income either. Conversely, a trust might grant a beneficiary a withdrawal right over income attributable to principal, but not accounting income, and this would shift only that income (e.g. *not* the interest, dividends, rents) to the beneficiary. But a trust could easily define the withdrawal right to include capital gains or taxable income from a particular asset, or all assets of a trust. Courts must look to the definition of income in the withdrawal right under the trust instrument, and if a beneficiary can withdraw capital gains, then the

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296 There are colorable arguments that a sole beneficiary/trustee might also trigger §678(a) even when limited by an ascertainable standard, but this is debatable and generally unreliable for proactive planning purposes. Most cases (and you can find many by shepardizing the *Mallinkrodt* case) find that even the slightest limitation will take a powerholder out of grantor trust status. This paper will assume there are no forfeiture provisions, consent requirements, duties or purposes otherwise fettering the right. See pages 17-20 of Howard Mobley’s outline at [http://www.howardmobley.com/articles/FixingBrokenTrusts.pdf](http://www.howardmobley.com/articles/FixingBrokenTrusts.pdf) and Jonathan Blattmachr, Mitchell Gans and Alvina Lo’s article at [http://ssrn.com/abstract=1511910](http://ssrn.com/abstract=1511910). Also, read the surprising conclusion of the penultimate paragraph of *Koffmann v. U.S.*, 300 F.2d 176 (6th Cir. 1962).
297 See *Uniform Principal and Income Act*, §409, §404
298 Treas. Reg. §1.671-3(b)(2)
beneficiary must report the capital gains.\textsuperscript{299} It is not optional to report under Subparts A-D of Subchapter J and/or have the trust be liable for the tax.

Treasury Regulations are crystal clear that “income” in §678(a) refers to taxable income, not accounting income:

“(b) Since the principle underlying subpart E (section 671 and following [26 USCS §§ 671 et seq.]), part I, subchapter J, chapter 1 of the Code, is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. Accordingly, when it is stated in the regulations under subpart E that "income" is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes.”\textsuperscript{300}

This is in stark contrast to the definition of income for the rest of Subchapter J (non-grantor trusts), which defaults to a completely different definition that relies on trust accounting concepts.\textsuperscript{301} This is the source of significant confusion among attorneys and accountants.

Refusing to take the income is not relevant to the §678 analysis, nor is renouncing the right to prior income.\textsuperscript{302} Although a withdrawal power is effective for §678(a) regardless of a

\textsuperscript{299} For example, in \textit{U.S. v. De Bonchamps}, 278 F.2d 127 (9th Cir. 1960), the court found, in interpreting §678, that a life tenant should not be taxed on the income because they did not have the sole power to take the capital gains upon sale of the underlying asset. “We have concluded that, upon the record before us, the powers of these life tenants are not the equivalent of a power to vest in themselves the corpus of the estate or the capital gains in question.” (emphasis added, the court clearly implying that if they could have taken the capital gains, though not necessarily the entire corpus, it would have been taxed to the power holders).

\textsuperscript{300} Treas. Reg. §1.671-2 Applicable Principals

\textsuperscript{301} § 1.643(b)-1 “Definition of income. For purposes of subparts \textbf{A} through \textbf{D}, part I, subchapter J, chapter 1 of the Internal Revenue Code, “income,” when not preceded by the words “taxable,” “distributable net,” “undistributed net,” or “gross,” \textbf{means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law}. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.****

\textsuperscript{302} \textit{Grant v. Commissioner}, 174 F.2d 891 (5th Cir. 1949).
beneficiary’s legal capacity, it would be prudent to specifically allow an agent under a durable power of attorney or court-appointed conservator or guardian to exercise the right.\footnote{Generally GPOAs are unaffected by a powerholder’s incapacity, see various cases cited in footnote 74. IRC §678(a) should follow – see Rev. Rul. 81-6, holding that a minor beneficiary is deemed owner for §678 even if local law requires court appointed guardian and none has yet been appointed.}

If a trust has a 5% of corpus withdrawal power, then 5% of the taxable income should be reported on the powerholder’s Form 1040 (regardless of whether it lapses or is taken).\footnote{Rev. Rul. 67-241: Widow had a typical 5/5 power (over the greater of $5,000 or 5% of the trust corpus). “Since the widow has a power exercisable solely by herself to vest a portion of the trust corpus in herself, she is treated as the owner of that portion of the trust under section 678 of the Code. As the owner of a portion of the trust corpus, there are included in computing her tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. Pursuant to the provisions of section 1.671-4 of the regulations, these items should not be reported by the trust on Form 1041, U.S. Fiduciary Income Tax Return (for estates, and trusts), but should be shown on a separate statement to be attached to that form. The portions of trust corpus considered owned by the widow are not subject to the provisions of sections 661(a)(2) and 662(a)(2) of the Code when distributed to her.”}

If the powerholder has the power to withdrawal up to $30,000 from taxable income, then that much should be reported directly on the powerholder’s Form 1040, subject to the trustee’s grantor trust reporting requirements under Treas. Reg. §1.671-4.\footnote{In Townsend v. Commissioner, 5 T.C. 1380 (1945), the beneficiary, pursuant to a state court order after a dispute, had the unfettered right to withdraw up to $30,000 annually, and the tax court held this much must be reported directly on the powerholder/beneficiary’s tax return. Also, see Rev. Rul. 67-241 quoted above.}

\footnote{Generally, non-pro rata distributions in kind to fund a pecuniary amount can trigger taxation known as Kenan gain, and non-pro rata divisions of even a residuary do the same if there is no trustee authority pursuant to Rev. Rul. 69-486, but most trusts nowadays should have the power to do this. See UTC §816(22).}

\footnote{Mallinckrodt v. Nunan, 146 F.2d 1 (8th Cir. 1945), this same reasoning is followed in other cases where beneficiaries had no withdrawal right over the entire principal, but only the income. E.g. Spies v. United States, 180 F.2d 336 (8th Cir. 1950), Goldsby v. Commissioner, T.C. Memo 2006-274 (where taxpayer/beneficiaries attempted to get an individual charitable deduction, arguing that a conservation easement contribution from the trust came from income taxable to the beneficiary under §678 – the tax court found that 678(a) applied, and a charitable deduction would be allowed if it came from a taxpayer’s grantor trust portion, but ultimately denied the deduction since the contribution was not traced to income. The parties and court inexplicable ignored §678(a)(2), which may have helped the taxpayer get a pro rated deduction).}

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The granddaddy of all grantor trust cases, Mallinckrodt, from which Congress basically codified in 1954 into IRC §678, concerned a father who established a trust for his son, his son’s wife and their children.\footnote{The son’s wife was to get $10,000/yr, and the son could not withdraw anything more.}
withdraw any income above that. The trustee reported all the income, including the undistributed income that the son could have withdrawn but did not, and deducted the $10,000 distribution to the wife. The court held that reporting of income/deduction for the $10,000 was proper, but that the undistributed income that the son could have withdrawn, but did not, must be reported on his tax return as income:

[The] “power of the petitioner to receive this trust income each year, upon request, can be regarded as the equivalent of ownership of the income for purposes of taxation.*** income is taxable to the possessor of such power, and that logically it makes no difference whether the possessor is a grantor who retained the power or a beneficiary who acquired it from another.*** Since the trust income in suit was available to petitioner upon request in each of the years involved, he had in each of those years the "realizable" economic gain necessary to make the income taxable to him.”308

While Mallinckrodt did not specify or discuss whether capital gains was included in the trust’s definition of withdrawable income, it is clear from the case that if it were, it would be taxable to the powerholder. Another irrevocable trust from a recent case had this clause:

“The net income from said trust shall be distributed by the Trustee to the beneficiaries [petitioner and Kathleen], jointly or the survivor of them, not less than once each year ***. Provided, however, the Trustee shall distribute only that part of the net income which is derived from Capital gains as is requested each year by the beneficiaries and if no such request be made then all of such capital gains shall be retained as a part of the Trust fund and be reinvested as principal.”309

The beneficiary did not request and the trust did not distribute the capital gains income, although the beneficiary could have clearly requested it. Citing Mallinckrodt, the tax court held that:

“Section 678(a)(1) clearly provides that a person with the power, exercisable solely by himself, to vest the corpus or the income in himself will be treated as the owner of that portion of the trust over which his power exists. Here, Kathleen and petitioner had the power exercisable solely by themselves to receive the King Trusts' capital gains income. Accordingly, pursuant to section 678(a)(1), petitioners are deemed to be the owners of the capital gains income from the King Trusts.”310

308 Id. at 5
309 Campbell v. Commissioner, T.C. Memo 1979-495
310 Id. at 16
Thus, with the plain language of §678(a), regulations under §1.671-2 and longstanding case precedent, it’s clear that beneficiaries with withdrawal rights over trust income (including capital gains) **MUST** report any such income on their Form 1040 – failure to do so may lead to substantial penalties, especially since *there is no substantial authority to argue otherwise*.

To understand the practical basics, let’s go back to Barbara’s bypass trust in our example above: with a fully §678(a) trust in which Barbara can withdraw all taxable income, including capital gains, Barbara would simply report all $140,000 of taxable income on her Form 1040 regardless of what she actually receives, and the trust has no income.\(^{311}\) A trust could be partially subject to §678(a). If Barbara only had an unfettered right to withdraw accounting income (interest, dividends, rents), then $40,000 would go onto her Form 1040 (ultimately, the same as if it had been K-1’d), and deductible expenses would have to be pro-rated accordingly.\(^{312}\) Similarly, if Barbara had a cap, e.g., up to $100,000 – then she would only be taxable to the cap, and expenses would be prorated accordingly (regardless of whether she actually takes the $100,000). If Barbara sends some of her withdrawable income to charity, she (not the trust) would be eligible for a Schedule A tax deduction under §170.\(^{313}\)

A fully “beneficiary income-controlled” or “beneficiary-defective” §678(a) grantor trust does have more than a few advantages and may be useful in specific situations. For instance, it may be preferable that certain assets, such as a personal residence, non-qualified annuity or qualifying small business stock, be owned by a §678(a) trust, because of the preferred tax treatment that individual Form 1040 taxpayers may avail themselves of that non-grantor trusts simply can’t.\(^{314}\) The most ubiquitous and valuable benefit, §121, is discussed in its own section below.

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311 Or, more accurately, no income to report under Subparts A-D of Subchapter J, but under Subpart E grantor trust
312 See various portion rules discussed in Treas. Reg. §1.671-2 and §1.671-3, some expenses might be attributed to the asset producing the income, and some, like a trustee fee, might be prorated.
313 *Goldsby v. Commissioner*, T.C. Memo 2006-274
314 Arguably, a §678(a) trust should avoid arguments that the trust is not an “agent for a natural person” pursuant to IRC §72(u). See *The Advisor’s Guide to Annuities*, by Michael Kitces and John Olsen. Non-qualified annuities, perhaps even more so than IRAs/Qualified plans, are best left to spouses outright unless the negatives of outright bequest (higher state estate tax, protection for other family, vulnerable spouse, etc.), outweigh the income tax benefits potentially lost by using a trust (which will depend on the gain in the contract). For small business stock exclusion and rollovers, see IRC §1202 and §1045
Surprising to many people, estates and non-grantor trusts are not eligible for the juicy $500,000 §179 expensing depreciation deduction – that alone should be a reason to allow for toggling to a beneficiary defective status for portions of the trust attributable to a capital intensive pass through entity business. Grantor trusts are also eligible S corporation stockholders, regardless of whether there is a QSST or ESBT election, but it cannot be partially grantor as to accounting income only. A grantor trust may allow much better treatment of any suspended passive losses due to insufficient basis in the S corp stock upon termination of the trust, which would simply be lost to a typical ESBT beneficiary. Though more rare, provisions for taking $50,000/$100,000 ordinary rather than capital losses for sales of small business stock are unavailable to trusts, but should be available to a beneficiary under a §678(a) structure.

In fact, there is no reason that the trust cannot provide different standards for income from these special assets (beneficiary withdrawal as opposed to traditional trustee distribution), in some cases as a separate subtrust, but you would not necessarily have to (somewhat akin to some practitioners’ preference for standalone IRA trusts).

Another unique advantage of using §678(a) over using DNI distributions to shift income to the beneficiary from the trust is the ability to limit it to taxable income. Let’s change our example above so that $30,000 of the $40,000 trust income is from municipal bonds – tax exempt income. A §678(a) power can be over all assets except the muni bonds, allowing the tax-exempt assets to stay trapped in trust without requiring withdrawal or

315 IRC §179(d)(4), although if the income is going to be earmarked to a specific beneficiary, then a QSST election may solve the issue if an S corp– QSSTs are in many ways de facto §678(a) trusts, see e.g., Treas. Reg. §1.1361-1(j)(8), but the §678(a) solution may be a good solution for an LLC/LP taxed as a partnership. The generous $500,000 expensing provision is temporary- the law is due to revert to $25,000 in 2014, but Congress may extend or modify that amount and there are various bills proposed to do so.

316 IRC §1361(c)(2)(A) “the following trusts may be shareholders: (i) A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States.” Subpart E of part I of subchapter J is referring to IRC §§671-679, which includes §678(a) of course. PLR 2012-16034 recently followed this, ruling that a beneficiary-grantor trust created via Crummey power qualifies as an S corp shareholder. Conservative practitioners may want to file a QSST election as a “belt and suspenders” approach, but this is a great back up in case that election failed to be properly filed. For most purposes, except perhaps for sale of the stock (where the QSST would no longer be treated as a grantor trust), it is the same for income tax purposes.

317 This is contrary to unused net operating losses, which a beneficiary “inherits” upon termination under IRC §642(h). There is a good argument that suspended S corp losses are personal and not transferred: IRC §1366(d)(1) and Treas. Reg. §1.1366-2(a)(5)(i)

318 See IRC §1244, Treas. Reg. §1.671-3(a) and (a)(2)
deemed withdrawal (to the extent no additional distributions are made). This cannot be done with ordinary trust distributions, which must carry out non-taxable income as well as taxable income.

Many practitioners already segregate IRA/qualified plan assets into separate or even standalone trusts for various tax and administrative reasons.\textsuperscript{319} Taxpayers may need to use such special assets to fund a trust to exploit the state’s estate exclusion amount, and making it a beneficiary-defective trust as to the income generated therein may be a significant benefit, even if it is slightly more “leaky”.\textsuperscript{320} This asset protection drawback and inherent “leakiness” might be partially mitigated through a Crummey/hanging power wherein the beneficiary merely has a power to withdraw the taxable income and to the extent it is not withdrawn, the power lapses annually over 5%.\textsuperscript{321} Not to mention the investment policy of the trust.

Unlike a Crummey clause, forfeiture provisions (a.k.a. “cessor provisions”, usually embedded in a more robust spendthrift clause) can automatically cut off such a withdrawal right that is not needed to qualify for the annual gift tax exclusion in the event of creditor attack (with appropriate carve out for QSST/marital/conduit trusts), or a trust protector provision might do so as well. To keep within the \$678(a) “sole” power requirement, and improve asset protection, withdrawal rights can be limited to a window in time (e.g. December 15-31), similar to 5/5 power limitations often used, and cessor provisions should probably only become effective prospectively so as not to impugn the “sole power”.

There is no reason that a \$678(a) power has to be all or nothing, or even the same every year! It can be more targeted than the traditional distribution structure under Subchapter J, which does not allow tracing of types of income. For example, let’s say a trust


\textsuperscript{320} For instance, someone in Seattle could easily have a $1 million home, $1 million in other assets, and wants to fund the entire $2 million to exploit the $2 million because their spouse has the same amount of assets – not funding the bypass with the home might cause $200,000 or so in additional state estate tax. State-only QTIP trusts have the same issue. Washington state has a $2 million estate tax exclusion with 10%-20% rates.

\textsuperscript{321} IRC \$2514(c). However, the 5% would pertain to the taxable income available to withdraw, not the entire principal, as some authors in this area have assumed – see Rev. Rul. 66-87. If a beneficiary has the right to withdrawal $120,000 of income from a $2 million trust corpus, and does not take it, the lapse protection is $6,000, not $100,000. The lapse protection may differ for state creditor protection law than federal tax law. In many states, the protected amount in the above scenario would be $14,000 or $28,000, depending on whether the original donor was married at the time. UTC \$ 505(b), though many UTC states double the annual exclusion lapse protection, as in Ohio R.C. \$5805.06(B)(2), and some may omit it (Massachusetts).
grants the beneficiary the unfettered withdrawal right to all income attributable to all assets except the municipal bond portfolio, the stock portfolio and the Roth IRA. This leaves income from those assets (0%, 23.8% for LTCG/QD, 0% respectively) in trust, and only shifts taxation of any ordinary income rent, traditional IRA distribution, annuity or taxable interest to the beneficiary. This exploits a larger delta of the likely tax rates between a trust and beneficiary, i.e. a 43.4% or 39.6% trust tax rate down to a likely 15% or 25% taxed to the beneficiary. Or, it might be limited to only income attributable to assets other than the Roth and muni bonds.

This withdrawal power could also be capped – e.g., all income attributable to assets other than the muni bond portfolio above $12,150, or even reference an external criteria, such as income to a point until his/her taxable income exceeds $400,000/$450,000 top income tax bracket. This certainly complicates administration, however, and, similar to our discussions in Part III about formula powers, the desire to squeeze every last cent of tax savings leads to diminishing returns that may not be warranted because of greater complexity. Remember that a partial grantor trust also forces a portioning of any expenses, such as investment management/trustee, attorney fees, though directly attributable expenses (e.g. real estate taxes on the residence) may be traced and go with the §678(a) beneficiary (or non-grantor trust portion, as applicable to which portion is getting the income).\(^{322}\) Any structure with withdrawal rights over only certain types of assets would have issues if the beneficiary were the sole trustee or controlling investment trustee/advisor, and fiduciary duties and conflicts would have to be worked around even with an independent trustee, but it’s not insurmountable.

Despite the above possibilities, by far the most likely use for this is a family that wants to SIMPLIFY trust administration and accounting and ensure they could not be “worse off” income tax wise with a trust. This means a withdrawal power over all taxable income. Such a provision can eliminate a traditional 1041 filing, even though grantor trusts still have nominal reporting requirements.\(^{323}\)

As we discussed in Parts II and III, estate planning practitioners often pay short shrift to the possibility that assets decline in value (hence the common use of the term “step up”,

\(^{322}\) Treas. Reg. §1.671-3(a)(2)

\(^{323}\) See Treas. Reg. §1.671-4 for various alternative methods of grantor trust reporting compliance.
optimistically ignoring the fact that it may also be a “step down”). This is also an important concept to remember for ongoing income tax planning. If a non-grantor trust or estate incurs a net capital loss, this is usually completely wasted, unless it is a final year of termination, at which point it can pass out to beneficiaries and be used by them to the extent of gains, or up to $3,000 of ordinary income.\textsuperscript{324} By contrast, a grantor trust wherein the beneficiary is responsible for the gains and losses on a particular asset should pass through any capital losses directly to the beneficiary.\textsuperscript{325} In some circumstances, this can be a tremendous advantage to the beneficiary, and an overlooked reason to consider §678 trusts over the traditional paradigm.

While §678 withdrawal provisions shift the income taxation (and with it, the Medicare “surtaxation”),\textsuperscript{326} such powers bring up some negative ramifications:

- some slightly decreased asset protection (amounts currently subject to an unfettered withdrawal power are typically subject to the beneficiary’s creditors), but a forfeiture or shifting executory interest (cessor) clause and/or trust protector might easily cut that off to prevent much ongoing damage, since only the year’s accumulated income would be at risk, which frankly is not much worse than other trusts, since bankruptcy pulls in recent trust distributions regardless. An automatic provision is preferred to avoid fraudulent transfer issues, but a trust protector enables modification when no threat is imminent.\textsuperscript{327}

- slightly increased estate inclusion (amounts subject to withdrawal at death are in a beneficiary’s estate), but again, this can be mitigated so that the withdrawal right is not until the end of the year. A beneficiary would be unlikely to die with any includible right, it would be minimal, and in many cases there would be a testamentary GPOA causing inclusion anyway (as discussed in Part III of this paper).

- if assets are not withdrawn in a given year, it may result in a partially self-settled trust as to the beneficiary, which may have negative ramifications for asset protection or estate tax inclusion. However, a beneficiary might simply withdraw any amounts above the 5/5

\textsuperscript{324} IRC §642(h)
\textsuperscript{325} Treas. Reg. §1.671-3(a)
\textsuperscript{326} Treas. Prop. Reg. §1.1411-3(b)(5)
\textsuperscript{327} For discussion of fraudulent transfer failures using trust protector/decanting see Ferri v. Powell-Ferri: Asset Protection Issues, Perils and Opportunities with Decanting, Ed Morrow & Steve Oshins, LISI Asset Protection Newsletter #240, for efficacy of automatic forfeiture (cessor) clauses, see other CLE materials from author.
and/or state creditor lapse protection and if asset protection is desired, contribute it to an IRA/Qualified Plan, cash value life insurance, LLC, irrevocable gifting trust, self-settled asset protection trust or other protective structure.

Most tax preparers (and attorneys) are neither educated on these concepts nor prepared to evaluate such trusts, so if §678(a) provisions are added, add an explanatory sentence or two (in bold, not buried in the boilerplate) describing the intention of the clause and its intended tax effect to alert trustees and their advisors. Statements of intentions may also help with any future reformations.

c. IRC §678(a) – Seizing the $250,000 capital gains tax exclusion for residence under §121

The most common of the tax savings opportunities for a grantor trust to encounter, applicable to the sub-$5.43 million dollar estates as well as the wealthiest, is the capital gains exclusion on the sale of a principal residence. A provision to withdraw capital gains from the sale of a residence, as discussed above, creates a §678(a) trust as to that asset upon sale. Such a provision as to residential property, but not other assets, avoids many of the negatives of §678(a) trusts. For example, there is very little asset protection risk granting a beneficiary the right to withdraw capital gains income from sale of a personal residence if an independent trustee doesn’t sell the property (assuming the trust does not require it, which would be rare)! A trust might allow the beneficiary to withdraw net capital gains from the sale of a residence, but have ordinary distribution provisions for all other assets.

Grantor trusts are permitted this exclusion provided the other occupancy requirements are met. A non-grantor trust is not eligible for the $250,000/$500,000 capital gain exclusion on the sale of a personal residence provided by §121, but §678 trusts are specifically included in the regulations. A mere right to occupy and use the property is

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328 See Rev. Rul. 66-159, Rev. Rul. 85-45 and PLR 1999-12026, in which the IRS looked through the trust to the beneficial owner under §678(a) for qualification under IRC §121 and its predecessor. Although in those cases the beneficiary had a right to withdrawal the entire trust principal, not just the capital gains from the sale of the home, the statute should equally apply if all the capital gains are subject to withdraw. This is perfectly consistent with Treas. Reg. §1.671-3(a)(2) and IRC §678(a).

329 Treas. Reg. §1.121-1(c)(3): “(i) Trusts. If a residence is owned by a trust, for the period that a taxpayer is treated under sections 671 through 679 (relating to the treatment of grantors and others as substantial owners) as
insufficient to cause grantor trust status necessary for the §121 exclusion. If the trust is partially a grantor trust, such as a trust with a five and five power, then the grantor may exclude that portion of the gain.\textsuperscript{330} Of course, the goal with this type of provision would be to grant the withdrawal right over the capital gain from the sale, not the income – and not tied to 5% of corpus. The portion rules, remember, can be tied to specific assets.

This is no small benefit – with federal long-term capital gains rates at 23.8%, the effect of Pease limitations at approximately 1.2% for itemizers, the phase out of personal exemptions, effect on social security taxation and other deductions/credits, indirect effect on alternative minimum tax, and state and local income taxes at up to 13.3%, there could easily be a tax cost of $100,000 if this $250,000 tax exclusion is lost. The exclusion is double two years after death, but more important for the long term, surviving spouses often remarry!\textsuperscript{331} If their new spouse meets the two year occupancy requirement, hasn’t used the provision themselves in the last two years and they file jointly, the exclusion is doubled, even if only one spouse is deemed the owner through §678 of 100% of the trust.\textsuperscript{332} Thus, losing this tax break could easily mean $500,000 of avoidable long-term capital gains income. When we consider the remarriage scenario, we’re getting close to a $200,000 income tax effect. Have fun explaining that to the surviving spouse if it’s lost.

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\textsuperscript{330} PLR 2001-04005 (bypass trust w/ 5% withdrawal power eligible for at least 5% of capital gains exclusion as partial grantor trust, thought the PLR did not discuss the possibility of higher % based on prior lapses/release).

\textsuperscript{331} Statistics show that widowers are more likely to remarry much sooner after a death of a spouse than widows.

\textsuperscript{332} See IRC §121(b)(4) and IRC §121(b): (2) Special rules for joint returns. In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property—

(A) $500,000 Limitation for certain joint returns Paragraph (1) shall be applied by substituting “$500,000” for “$250,000” if— (i) either spouse meets the ownership requirements of subsection (a) with respect to such property; (ii) both spouses meet the use requirements of subsection (a) with respect to such property; and (iii) neither spouse is ineligible for the benefits of subsection (a) with respect to such property by reason of paragraph (3).

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(3) Application to only 1 sale or exchange every 2 years

Subsection (a) shall not apply to any sale or exchange by the taxpayer if, during the 2-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which subsection (a) applied.
Trustees must normally make property productive of income, but trusts routinely permit the trustee to invest in or retain a contributed residence for a beneficiary and specific language should be considered on this point.\footnote{333 Uniform Prudent Investor Act (Restatement of Trusts, 3rd), §181} The QTIP marital deduction, of course, permits a surviving spouse’s use of a residence to qualify for the marital deduction, provided the spouse is entitled to any rent income if the property is later vacated as a residence.\footnote{334 Treas. Reg. § 20.2056(b)-5(f)(4), Treas. Reg. §20.2056(b)-7(h) Example 1, Commissioner v. Plant, 76 F.2d 8 (2nd Cir. 1935); PLR 8341005; A.I. DuPont Testamentary Trust v. Commissioner, 574 F.2d 1332 (5th Cir. 1978) and 514 F.2d 917 (5th Cir. 1975).} There are other income tax traps when a residence used by a beneficiary is owned and maintained by the trust. The amounts spent by the trustee to maintain the residence \emph{are generally not deductible and not considered to have been distributed to the beneficiary}.\footnote{335 Commissioner v. Plant, 76 F.2d 8 (2nd Cir. 1935); PLR 8341005; A.I. DuPont Testamentary Trust v. Commissioner, 574 F.2d 1332 (5th Cir. 1978) and 514 F.2d 917 (5th Cir. 1975).} Trustees can easily botch this accounting. Even if this is reported correctly, it may lead to more trapped and taxed in trust than necessary, as opposed to the greater simplicity of simply making distributions and letting the beneficiary pay. The mortgage interest deduction should be allowed to the extent paid by the beneficiary.\footnote{336 Treas. Reg. §1.163-1(b) (equitable ownership sufficient)}

The beauty of this more limited provision of permitting withdrawal of the capital gains from the sale of the residence is that it has NO effect on the grantor/non-grantor trust status of the trust until such time as the withdrawal right is triggered (upon sale), simplifying reporting. When the trust reverts back to a fully non-grantor trust, the distribution provisions of the trust can simply take into account the earlier distribution of capital gains as part of the surviving spouse’s available resources.

d. \textit{Application to Special Needs Trusts, Medicaid qualification}

It is probably stating the obvious, but a §678(a) power would not work in a special needs trust scenario – the trust would be considered a countable resource to the beneficiary. Although in theory one could give such a §678(a) power to a sibling or someone other than the special needs beneficiary, this is probably contrary to the settlor’s intent, impairs protection for the special needs beneficiary, and may cause \emph{higher} income taxation among the family unit – not only would a special needs beneficiary getting a K-1 be in a lower bracket...
typically, but qualifying non-grantor trusts for special needs beneficiaries (a “qualified disability trust”) even receive an additional personal tax exemption.\textsuperscript{337} If the original grantor is still living, grantor trust status for these work well, but it’s probably best to stick to ordinary non-grantor status upon the death of the original grantor for such trusts.

e. **Application to QTIP trusts?**

The common wisdom is that QTIP require all income be paid annually to the surviving spouse, therefore a QTIP cannot be a fully §678(a) trust. Once again, the common wisdom is wrong. Rather than mandate all income be paid annually, marital trusts can merely require that the spouse be able to withdraw all income annually.\textsuperscript{338} As discussed above, this can make a huge difference under Subchapter J. This floor of the right to withdraw net accounting income required by IRC §2056 can certainly be increased to include the greater of the net accounting income or the taxable income (which would usually be higher), including capital gains, or other taxable income that would not be accounting income (e.g., a $50,000 IRA payment might be $5,000 accounting income, but $50,000 taxable income).

How viable is this? It largely depends on what the settlor would want. Many, even in some blended families, would be fine with this, and it could arguably allow for a much easier to understand and simplified reporting structure. Normal people think in terms of taxable income (W-2, 1099), not “DNI” and “FAI”. No surviving spouse thinks that the $50,000 IRA distribution from the $1 million IRA should entitle him or her to only $5,000 of “income”. The pressures on the trustee might be slightly different – instead of a surviving spouse insisting on high-yield, income producing property, the focus might shift to realizing long-term capital

\textsuperscript{337} IRC §642(b)(2)(C), tied to personal exemption, $3950 in 2014, rather than $100 for typical complex trusts.

\textsuperscript{338} Treas. Reg. §20.2056(b)-5(f)(8): “In the case of an interest passing in trust, the terms "entitled for life" and "payable annually or at more frequent intervals," as used in the conditions set forth in paragraph (a) (1) and (2) of this section, require that under the terms of the trust the income referred to must be currently (at least annually; see paragraph (e) of this section) distributable to the spouse or that she must have such command over the income that it is virtually hers. Thus, the conditions in paragraph (a) (1) and (2) of this section are satisfied in this respect if, under the terms of the trust instrument, the spouse has the right exercisable annually (or more frequently) to require distribution to herself of the trust income, and otherwise the trust income is to be accumulated and added to corpus.” Treas. Reg. §20.2056(b)-7(d)(2) governing QTIPs looks to the above Reg for its definition of the required income interest: "(2) Entitled for life to all income. The principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.”

152
gains! Like anything new, it would require thinking through the prior modus operandi. But
explaining the income taxation to clients would be infinitely easier. If you don’t agree, you’ve
never taken a fiduciary income tax course or tried to explain trust taxation to a client.

f. **Transactions between beneficiaries and fully §678(a) trusts as to beneficiaries**

Many readers are undoubtedly wondering – since these techniques can create what is
considered a grantor trust to the beneficiary as to ALL trust income, what is to stop
beneficiaries from engaging in installment sales, swaps or other transactions with their fully
§678(a) trusts under Rev. Rul. 85-13 and its progeny? Isn’t this like the BDIT (which relies
on lapses of powers over the entire corpus per §678(a)(2)), but with an unlimited seed gift,
rather than a mere $5,000, and with less risk? Isn’t this much more certain than an
installment sale to a completed gift asset protection trust with the settlor as beneficiary, with
its attendant §2036 risk? Isn’t this safer than a beneficiary sale to a qualified subchapter S
trust (QSST), which is only a grantor trust as to the income rather than the entire corpus if the
S corporation stock is sold? Comparing “beneficiary income controlled trusts” transactions
with installment sales to BDITs, QSSTs and other grantor trusts will be considered in a
separate article.

g. **Using Treas. Reg. §1.643(a)-3(b)**

The best solution to solving the capital gains tax trap in most cases is to utilize one of
the three methods noted in the Treasury Regulations to allow capital gains to be treated as
part of the DNI deduction. This will allow any discretionary distributions to the beneficiary to
carry out capital gains as part of DNI so that the K-1 can take care of the surtax and higher tax
rate issue by putting the capital gains on the beneficiary’s Form 1040.

Once capital gains are part of the DNI deduction, they can be carried out on the K-1
and taxed to the beneficiary. So, how do we get out of the default rule that capital gains are
not ordinarily part of DNI? Generally, they will be included if they are 1) allocated to

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339 Exceptions may be necessary for QTIP beneficiaries for IRC §2519 reasons, as discussed in Part VIII.k, or
gantor-CLT trust owners, who would have self-dealing issues
340 See Treas. Reg. §1.643(a)-3(a) for this default
fiduciary accounting income or 2) allocated to principal and “paid, credited or required to be distributed to any beneficiary during the year”. The regulations regarding these exceptions are more specific and merit full inclusion here:

“(b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)—

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph §1.643(a)–3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust’s books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.”

Let’s discuss these out of order, taking the easiest and “cleanest” first. The second method, (b)(2), is very straightforward. The trustee simply treats capital gains consistently as part of the beneficiary’s distribution. Ideally, language in the trust will address this, which might even give some cover in case the trustee failed to be consistent. For new estates and trusts, this is quite easy. For an existing trust, there is a question whether it can change this

341 IRC § 643(a)(3)
342 Treas. Reg. §1.643(a)-3(b)
343 Example: "To the extent that discretionary distributions are made from principal, the trustee shall make them and/or account for them in the books, records and tax returns of the trust in the following order:
  1) from any current year net short-term capital gains, except those net gains attributable to disposition of property held in a trade or business not described in IRC §1411(c)(2), or attributable to disposition of an active trade or business as described in IRC §1411(c)(4);
  2) from any current year taxable income attributable to assets described in IRC §1411(c)(1)(A)(i), such as an annuity payment, that was allocated to principal.
  3) from any current year taxable income attributable to a qualified retirement plan distribution described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b) allocated to principal
  4) from any remaining current net short term capital gains not described in paragraph 1
  5) from any current long-term capital gains, except those net gains attributable to disposition of property held in a trade or business not described in IRC §1411(c)(2), or attributable to disposition of an active trade or business as described in IRC §1411(c)(4);
practice when in prior years it has been consistently NOT treating capital gains as part of a beneficiary’s distribution.\textsuperscript{344} Potential remedies of amendments and decanting will be further discussed below.

The third method, (b)(3), is slightly more problematic. It can be divided into two methods – the first is to “actually distribute” capital gains. This presumably means tracing the proceeds. So, the trustee takes the proceeds from the sale and gives the net capital gain therefrom to the beneficiary. This sounds easier than it is. For instance, what if principal distributions are needed early in the year and cannot wait until later when the net gains can be determined? What about “phantom” capital gains from a pass through entity or fund?

In lieu of tracing, the third method also allows capital gains to be part of DNI if the trustee, “pursuant to a reasonable and impartial exercise of discretion” uses capital gains “in determining the amount that is distributed or required to be distributed”. Very few trusts would use capital gains as part of a distribution provision where gains determine the amount “required to be distributed”. For instance, a trust might say that “gains from the sale of a particular business property shall go to beneficiary X.” In theory, the trust could mandate that “the trustee pay all (or X%) of net income and net capital gains to the beneficiary” to invoke this section, but if these were the goals, it would make more sense to use §678(a), not §1.643(a)-3(b)(3).

What if the trustee doesn’t mandate that capital gains be used in determining the distribution, but the trustee simply states “I hereby swear I considered capital gains to determine how much to distribute in my discretion from this trust this year”? Some attorneys are more optimistic than I that mere trustee policy can be relied on to come under (b)(3), but arguably it only requires “utilization by the fiduciary”, not any required mandate in the

\textsuperscript{344} Most recently, the IRS recognized this problem but was quite cold-hearted about it: “If the tax imposed by section 1411 had existed in the year that an existing trust or estate had first incurred capital gains, the fiduciary may have exercised its discretion differently. The commentators request that the final regulations allow a fiduciary a “fresh start” to determine whether capital gains are to be treated as part of DNI. The final regulations do not adopt this suggestion.*** the potential for fluctuations in the effective tax rate on capital gains is a factor that is foreseeable by fiduciaries making these elections.” You should have known something like ATRA would pass!!!! From page 33-34 of the final §1411 regulations at https://s3.amazonaws.com/public-inspection.federalregister.gov/2013-28410.pdf
One could argue that common law fiduciary duties of prudence would permit the trustee to consider gains as a factor. However, it would be more certain if the trust document specifically required or at least expressly permitted the trustee to consider capital gains. A non-judicial (private) settlement agreement is a good solution here to add such a sentence, since this is not the kind of drastic change that might require a court reformation.

The first method, (b)(1), offers more flexibility than the latter two, but potentially offers more complexity and liability for the trustee, because it involves changing the scheme of principal and income allocation and requires additional trustee discretion.

For many modern trusts, the distinction between principal and income is anachronistic. These distinctions are often meaningless in determining what beneficiaries receive from the trust. However, they are still important for tax purposes.

Corollary to the above regulation, Treas. Reg. §1.643(b)-1 states that:

“In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.”

Thus, in theory, not only could capital gains be allocated to income, but it can be done at the trustee’s discretion. Sections 103-104 of the Uniform Principal and Income Act, which provides the default principal/income rules in most states, allow a trustee to make adjustments to income and principal, in theory. However, the default prerequisites and rationale for invoking these provisions do not fit our proactive tax planning example above,

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345 See Including Capital Gains in Trust or Estate Distributions After ATRA - A frequently overlooked regulation may give fiduciaries more flexibility than they realize, Trusts and Estates, March 2013, by Frederick Sembler.
346 Example. “In exercising the trustee’s discretion noted above to distribute principal, my trustee shall consider any capital gains realized by the trust as a relevant, but not exclusive, factor in determining the extent of any discretionary distribution. It is my intention that this provision comply with Treas. Reg. §1.643(a)-3(b)(3) to permit the trustee to include capital gains in distributable net income .”
347 This is in spite of an admonition earlier in the same regulation that “Trust provisions that depart fundamentally from traditional principals of income and principal will generally not be recognized”. This ability of the fiduciary to “manipulate” tax consequences through its discretion pursuant to this regulation has generally been respected. See BNA Portfolio 852-34, Acker, A67 and authorities cited therein.
where the goal is simply to shift taxation of the capital gains that is arguably already being distributed to the beneficiary.

But this does not mean that a trust cannot be drafted to override Section 103-104’s limitations. Section 103(a)(1) first requires a fiduciary to “administer a trust or estate in accordance with the trust or the will, even if there is a different provision in this Act”. Section 103(a)(2) further permits a trustee to “administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this Act.” Thus, the attorney merely has to override the UPIA default to grant wider discretion to allocate between principal and income (perhaps, to the extent of discretionary distributions), while keeping in line with both state law and Treas. Regs. §1.643(b)-1 and §1.643(a)-3(b).348

Discretion to exploit such adjustments is best done by an independent corporate trustee, rather than a beneficiary/trustee, especially if there is “all net income” language. So, how would our power to adjust solution work under our bypass trust example above? The independent trustee would adjust all (or most) of capital gains to accounting income, then the $75,000 distribution becomes part of DNI and the distribution deduction is K-1’d out to the beneficiary, taxed at her much lower rates.

h. **Comparing the three methods under §1.643(a)-3(b)**

The second method (b)(2) is the simplest and probably preferred for most new trusts without any inconsistent past reporting, where it’s unlikely that the parties would want to change the scheme (e.g. if the beneficiary is anticipated to be in a high tax bracket and high state income tax state but the trust is not a resident trust of a high tax state, then perhaps it’s more tax efficient to trap capital gains in trust). It’s doubtful that decantings or other

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348 Example: “Pursuant to Section 103 of the UPIA [or state UPIA citation], I hereby override the state law default treatment of allocation of capital gains to trust principal as follows: any Trustee who is neither a beneficiary nor “related or subordinate” (as those terms are defined in IRC § 672) to any beneficiary of a trust may reallocate capital gains income from fiduciary accounting principal to fiduciary accounting income in the sole discretion of the trustee. In doing so, the trustee may consider the net tax effect of the allocation to the trust and the beneficiary together, such as whether leaving capital gains as taxable to the trust would cause more tax than simply grossing up the distribution and allocating capital gains to income to achieve the same after tax result to the beneficiaries.”
amendments can successfully change the method once set in place – if such be the case one of the other methods would be preferred.

The first method, (b)(1), may offer more flexibility, but there would be the additional complexity of changing internal trust principal/income accounting. Plus, how much guidance do we have on what is “reasonable and impartial” (more an issue for “all net income” trusts)?

The third method, (b)(3), seems much easier, and is promising if the trust has language requiring consideration of capital gains in the distribution decision. In contrast to (b)(2), it does not require the trustee to be “consistent” in its treatment of capital gains as part of DNI.

There are certainly unanswered questions about how far trustees can push the envelope – would the IRS ever argue that the trustee is not being “reasonable and impartial”, as required under all three methods? Would the IRS ever scrutinize and police how the trustee is “utilizing” capital gains as a factor in discretionary distribution decisions? Since fiduciary tax returns have the lowest audit rate of any income tax return, it’s unlikely we’ll get clear answers soon, if ever, but also extremely unlikely the IRS would ever take up that banner with so many more easier to win and more abusive tax schemes to battle. After all, Treasury gave extremely wide latitude to trustees with these regulations.

i. Issues with Adapting Irrevocable Trusts with Prior Tax Reporting History

In the case where a trustee has been historically not been treating capital gains as part of distributions in its “books, records, and tax returns”, query whether a private settlement agreement, decanting or other reformation to prospectively change this would have any impact, for instance incorporating something akin to the sample language above? Arguably, the trustee would thereafter be consistent in its treatment of capital gains pursuant to the new governing instrument. Would the IRS permit a one-time change? The IRS may not consider it to be a new trust for Treas. Reg. §1.643(a)-3(b) purposes simply because of a minor administrative amendment, and might therefore regard the new treatment of capital gains as inconsistent with prior practice. After all, trustees don’t typically get a completely new EIN for such changes, but it’s unclear whether it would matter if they did. Because of this substantial uncertainty, practitioners might seek a private letter ruling to adapt existing trusts that have a
history of not treating capital gains as part of distributions pursuant to the (b)(2) exception. It’s probably more certain, and a lot cheaper, to simply use one of the other two methods mentioned above.

**j. Impact of changing tax burden on beneficiary distributions**

Going back to our example, if capital gains are considered part of Barbara’s distribution and ordinary non-grantor trust rules are applied, not only the $40,000 of accounting income but the $75,000 of principal distribution is also taxed to her. Only $25,000 of capital gains is left trapped in trust. However, because of her extra personal tax burden, she would probably ask for approximately $20,000 in additional distributions to compensate, which would lower the income trapped in the trust to well under $12,400. Thus, the 43.4%/23.8% highest marginal trust tax rates are completely avoided and her personal rates of 28%/15% would be applicable. This can lead to tremendous ongoing tax savings. Even the remainder beneficiaries are happy because, although Barbara got $20,000 more in gross distributions under this planning, the trust saved more than that in taxes ($95,000 x 23.8%=$22,610, approx.), so they are better off as well.

Whether these techniques will save taxes depends on many factors, primarily the trust distribution provisions, state principal and income law, state taxation, preexisting tax attributes such as capital loss carry-forwards of the trust and beneficiary, and of course, the beneficiary’s income and deductions. However, in many cases of trust planning and administration for the vast majority of taxpayers, it will pay to rethink the trust boilerplate, administration and tax preparation as regards to capital gains starting in 2013.

Practitioners should review the terms of their trusts for discussion of how capital gains are accounted for in making trust distributions and/or allocated to fiduciary accounting income. For existing irrevocable trusts, attorneys should not only review the terms of the trusts as to how capital gains are accounted for, but they should also review how the trustee has historically handled the treatment of capital gains regarding the beneficiary’s distributions (Forms 1041 and K-1). An experienced corporate trust department would best ensure consistent documentation of the “books, records and tax returns” and ensure the IRS finds
“reasonable and impartial” use of discretion to comply with the regulations necessary to exploit these potential savings.

If the trustee has not been treating capital gains as a part of the beneficiary’s distributions (which is likely), consideration should be given to a private settlement agreement or reformation to either correct prospective treatment of capital gains on the “books, records and tax returns” of the trust, or, much better, amend the trust provisions regarding allocating capital gains to fiduciary accounting income and/or require consideration of capital gains in the trustee’s discretionary distribution decision process. In the latter cases, a professional and independent trustee or co-trustee should be considered to properly exploit this flexibility. Regulated trustees HAVE to paper the file, for the Office of Controller and Currency (OCC) or state auditors and internal accounting committees, with their considerations for discretionary decisions.

k. **Exploiting Spray Powers and Lifetime Limited Powers of Appointment**

Even better than having capital gains taxed to the beneficiary, the settlor may give additional spray powers to the trustee, to spray income to other beneficiaries, including the family’s favorite charity, donor advised fund or private foundation.\(^{349}\) Or, probably better in many ways, the settlor may give the surviving spouse and/or another party a limited lifetime power of appointment.\(^{350}\) For instance, let’s say Barbara receives more income outside the trust, putting her in a higher bracket, and decides that she only needs $30,000 from the trust, but her children could use funds to pay for grandchildren in college. She uses her limited power of appointment, or asks the trustee if there is a spray power or asks a collateral power holder if someone else has a lifetime power, to distribute $80,000 to her children (or

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\(^{349}\) Spray powers have practical issues that require careful drafting to protect the primary beneficiary and prevent a sense of entitlement by secondary beneficiaries. Typically language would be completely discretionary and instruct the trustee to consider secondary beneficiaries only after consideration of the primary beneficiary’s needs, or give the primary beneficiary (e.g. spouse) a veto power over secondary beneficiary distributions. Spray powers may also implicate additional reporting/accounting requirements.

\(^{350}\) This should not cause estate inclusion, nor a taxable gift, if it is properly circumscribed with support obligation savings clause provision to forbid distribution to someone whom the donee powerholder owes an obligation of support. See Treas. Reg. §20.2041-1(c)(1)(B). It could trigger a gift if exercised so as to trigger the Delaware Tax Trap, discussed elsewhere herein. IRC §2514(d). Or, it could trigger a gift if the powerholder has a testamentary GPOA over the same asset, as discussed elsewhere herein, which is a good reason to add a collateral power held by a family friend or other non-adverse party.
grandchildren) and $20,000 to the family’s donor advised fund at the local community foundation that John had also named in the trust as a permissible appointee/beneficiary.351 Whether this makes sense depends on the family situation, trust and brackets of the parties involved (and potentially the assets, such as whether an S Corp or IRA is involved, which would suggest using separate trusts or subtrusts).352 There are many scenarios where the family would be far better off with this spray capability, potentially lowering tax rates by 20% or more. Remember, the 0% rate for taxpayers in the bottom two tax brackets for LTCG/qualified dividends was “permanently” extended with ATRA as well.

I. Why QTIPs are (probably) terrible for tax shifting and what can be done (maybe)

Marital and QTIP trusts generally must require that the surviving spouse be the ONLY beneficiary entitled or eligible for income, so they are generally terrible vehicles for tax shifting. Or are they? Contrary to this commonly accepted wisdom, there is at least a good argument that a QTIP is able to give a surviving spouse a lifetime general power of appointment (aka 5/5 power). The tax code appears to disallow this unless it is only to appoint to the spouse, but two sections of treasury regulations appear contradictory, and there is a PLR directly on point allowing a spouse to appoint 5% to herself or others, with a

351 See IRC §642(c)(1) and Regs. The Supreme Court held in Old Colony Trust Co. v. Commissioner, 301 U.S. 379 (1937) that “pursuant to the governing instrument” in IRC §642(c) plainly includes discretionary distributions, and need not be pursuant to a mandatory requirement. There is some uncertainty, however, from later narrower decisions from lower courts. Generally, you would be more secure in getting the §642(c) deduction the more direct, certain and specific the trust’s charitable provision is, but a recent PLR followed the Supreme Court and permitted it for a discretionary distribution pursuant to a lifetime limited power of appointment. See discussion of such nuances in Chapter 6.08 of Federal Income Taxation of Trusts, Estates and Beneficiaries by Ascher, Ferguson, Freeland. Does a lifetime LPOA carry out income, since it is a power over specific property, not “income” or “principal”? Despite a tentative argument that appointing a specific asset might be a “specific gift or bequest” under the relation back doctrine and therefore not carry out DNI (Treas. Reg. §1.663(a)-1), other sections under that regulation indicate that even appointing a specific dollar amount or asset does carry out DNI under the same rules as any other trustee distribution to a beneficiary. This is the most logical interpretation, but I could find no specific authority. Regardless, a lifetime LPOA has enormous power and efficacy as a backstop to the trustee’s spray power, if not as a complete replacement. If the LPOA powerholder is a mandatory income beneficiary, however, it may be deemed a gift of the lost income. Estate of Regester, 83 T.C. 1 (1984), though contrary is Self v. United States, 142 F. Supp. 939 (1956). If the powerholder also has a testamentary GPOA it would be considered a gift as well. Treas. Reg. §25.2514-1(b)(2). A deemed gift may not be a problem with large applicable exclusion amounts and annual exclusions, but why not allow for both if the spray power is properly circumscribed, or better, add a limited collateral power if there is a trusted friend/advisor to the family.352 IRA “see through trust” rules don’t play well with most POAs and neither do QSSTs. ESBTs force higher rate taxation regardless of who the distributions are made to, so consider segregating those to separate trusts.
rather compelling rationale to interpret the regulation in such a manner.\textsuperscript{353} If the PLR and more importantly, such an interpretation of the regulation can be relied on, could this open up tax shifting opportunities?

A typical 5/5 GPOA would be awkward and inefficient to shift the income taxation, since any such power would normally trigger §678(a), making such income or at least a portion of it taxable to the powerholder rather than the ultimate recipient. However, just as we might craft testamentary GPOAs in QTIPs for better basis increase for fractional shares of assets owned between QTIPs and surviving spouses, as discussed in Part II, we might be able to craft a 5/5 power in a QTIP that can more efficiently shift income.

What if the 5/5 power was a GPOA for estate/gift tax purposes, but not a “sole power” for §678(a) purposes? This may be the best of all worlds, because an unexercised 5/5 power ordinarily is an unholy nightmare to administer and track, because every lapse creates a changing fractional grantor trust.\textsuperscript{354} For example, a power only exercisable with the consent of

\textsuperscript{353} The code seems to disallow: IRC §2056(b)(7)(B)(ii): “(II) no person has a power to appoint any part of the property to any person other than the surviving spouse.”, but we can rely on treasury regulations that are looser: Treas. Reg. §20.2056(7)(d)(6): “The fact that property distributed to a surviving spouse may be transferred by the spouse to another person does not result in a failure to satisfy the requirement of section 2056(b)(7)(B)(ii)(II). However, if the surviving spouse is legally bound to transfer the distributed property to another person without full and adequate consideration in money or money’s worth, the requirement of section 2056(b)(7)(B)(ii)(II) is not satisfied.” How would a GPOA where the spouse can transfer to herself and/or others via gift fit the Regulation? See PLR 8943005 for an example of the IRS approving a QTIP with a lifetime 5/5 GPOA allowing the spouse to transfer to herself or others up to 5% of trust corpus annually: “[w]e believe the better reading of the legislative history would preclude a spousal power of appointment only where the exercise of the power would not be subject to transfer taxation; i.e., where the power is not a general power of appointment as defined in section 2514 of the Code. An interpretation requiring that a spouse must first take physical possession of the property prior to a transfer to a third party, would focus too much attention on the form of the transaction. It is sufficient that the exercise of the power by the spouse in favor of a third party would be subject to transfer taxation.” Another regulation, however, seems to contradict the PLR and other Regulation above – Treas. Reg § 20.2056(7)(h), Example 4: “Power to distribute trust corpus to other beneficiaries. D’s will established a trust providing that S is entitled to receive at least annually all the trust income. The trustee is given the power to use annually during S’s lifetime § 5,000 from the trust for the maintenance and support of S’s minor child, C. Any such distribution does not necessarily relieve S of S’s obligation to support and maintain C. S does not have a qualifying income interest for life in any portion of the trust because the bequest fails to satisfy the condition that no person have a power, other than a power the exercise of which takes effect only at or after S’s death, to appoint any part of the property to any person other than S. The trust would also be nondeductible under section 2056(b)(7) if S, rather than the trustee, held the power to appoint a portion of the principal to C.” How can the two seemingly contradictory regulations and PLR be reconciled? In the former, the spouse’s 5%/5,000 power included the power to appoint to herself, in the latter, it did not. It is clear that no other party can have such a power. Treas. Reg. 20.2056(7)(h)

\textsuperscript{354} See PLR 9034004 – “During each succeeding year in which A fails to exercise her [5/5] power, A will be treated as the owner of an increasing portion of corpus of T. For purposes of determining the increase in her deemed ownership her current withdrawal power for any particular year will cause an increase in the amount of corpus which she is treated as owning equal to the product of the amount which she could withdraw multiplied by a fraction the numerator of which is the portion of trust corpus which she is not already treated as owning and the
a non-adverse party would be a GPOA under §2514/§2041, but clearly be insufficient to trigger beneficiary-grantor trust status as to the powerholder under §678(a). Therefore, such a circumscribed power may be used to shift income, or more likely in a QTIP, capital gains. How would this work?

Back to our previous example: Barbara’s QTIP trust has a 5/5 GPOA power requiring the consent of a non-adverse party to exercise. The trust corpus is $2 million and has ordinary income of $40,000 (equal to the trust’s accounting income and distributable net income (DNI)), short-term capital gains of $30,000, and long-term capital gains of $70,000. The trustee does not allocate capital gains to trust principal. The trustee must distribute to Barbara all of the accounting income ($40,000). Barbara appoints (orders the trustee to distribute) $100,000, which is 5% of the corpus, to her children, who are in lower tax brackets, and the trustee or some other non-adverse party consents to the transfer. Because §678(a) is not triggered, ordinary Subchapter J (Parts A-D) principals apply. Provided that the trustee’s “books, records, and tax returns” consistently treat such distributions as part of a distribution to a beneficiary, as discussed above, the trustee must send a K-1 allocating $40,000 of interest and dividends to Barbara and K-1s for the $100,000 in capital gains to her children, who may well be in a 0% LTCG or 15% STCG tax bracket. Even if the kiddie tax applied to use Barbara’s highest income tax bracket, the 3.8% surtax is probably avoided, since the kiddie tax only applies to income tax, not the Medicare surtax.

Barbara, in the example above, would trigger a taxable gift for the $100,000 transferred – if she had three children and made no other gifts, and the annual exclusion were $15,000 at the time, this would use $55,000 of her applicable exclusion amount. However, QTIPs have some additional quirks: IRC §2519 treats dispositions of a QTIP as a transfer of the entire interest for gift tax purposes. Neither the PLR nor the regulation mentioned §2519, nor has any case law developed on whether this could be a disposition. For planning purposes, it is probably prudent to assume that it could apply.

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355 Treas. Reg. §1.643(a)-3(b)(2)
356 IRC §2519(a)
The chief question point in this planning is the reliability of the PLR. While the PLR is exactly on point, we cannot rely on PLRs for precedent. While we can rely on treasury regulations, the two regulations cited above conflict – they might be reconciled, but it’s hard to be confident that the regulations clearly support the PLR enough for confident planning. Furthermore, §2519 is a huge question mark – many clients would accept triggering a taxable gift, which might even fly under an annual exclusion, but not want to trigger a gift tax on the entire QTIP. QTIP qualification is important even if the family does not need the marital deduction in the first to die’s estate, because they may be relying on that to pull the trust back into the second to die’s estate for a second basis increase.357

Why not just use a bypass (optimal basis increase) trust as noted above, which can get most of the advantages of a QTIP, with much more certain and more robust ongoing income tax advantages? Getting a PLR would probably only make sense for a wealthy family/ large QTIP to be worth the trouble. If you are inclined to add 5/5 powers to trusts (whether they are simply a power to appoint to self only, as many QTIPs do, or to self and others), please consider the above §678(a) avoidance techniques to avoid accounting nightmares.

m. IRC § 642(c) – Seizing better charitable deductions through trusts

Notably, not only would IRC §642(c) offer “above the line” charitable deductions for the family from the trust, up to the entire gross income, not subject to 20%/30%/50% AGI limitations, but it offers a better deal for internationally minded clients with ties/interests in foreign countries – unlike IRC §170 for individuals, the trust income tax charitable deduction is expressly not limited to charities organized in the U.S.358 Furthermore, unlike individuals, and even better than a 65 day election, a trustee can even elect to treat a contribution as made in a previous tax year, if the election is made by the due date of the income tax return and extensions, or even later if granted 9100 relief.359

357 IRC §2044 pulls any QTIP trust back into the surviving spouse’s estate for inclusion, allowing §1014 step up
358 Treas. Reg. §1.642(c)-1(a)(2). The income tax deduction for individuals may be allowed to some foreign charities in some cases pursuant to treaty, such as Israel, Mexico or Canada – see p. 3 of IRS Pub 526, 597; US-Canada treaty, http://www.irs.gov/pub/irs-trty/canada.pdf
359 IRC §642(c)(1): “If a charitable contribution is paid after the close of such taxable year and on or before the last day of the year following the close of such taxable year, then the trustee or administrator may elect to treat such
Unlike charitable contributions from individuals, which do NOT affect MAGI or net investment income or an individual’s 3.8% Medicare surtax exposure, the charitable contribution from a trust under §642(c) DOES reduce net investment income for purposes of the 3.8% surtax.\(^{360}\) It can carry out capital gains allocated to corpus.\(^{361}\) It can carry out IRD.\(^{362}\)

Furthermore, there may be substantial state income tax benefits to §642(c) deductions, over a §170 individual tax deduction. Many states don’t grant individuals a charitable deduction for state income tax purposes, or limit it, but states’ trust tax regimes often start with the taxable income number from federal Form 1041, line 22, which is calculated after the §642(c) deduction.\(^{363}\) Other states allow individual charitable deductions, but they are subject to Pease limitation phase outs.\(^{364}\) Saving another 5-10% state income tax can be substantial state income tax savings, even if there is state-source income, like selling a business or real estate located in state.\(^{365}\) More advantages may accrue if the trust’s donation were large enough to exceed an individual’s 20%/30%/50% AGI limitations, or if the individual beneficiary already had substantial carryforwards that would limit further use.

Furthermore, regulations specifically permit that the governing instrument can control the character of the income distributed via §642(c) provided it “has economic effect

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\(^{360}\) Treas. Prop. Reg. §1.1411-3(e)(2) and Treas. Prop. Reg. §1.1411-3(f) Ex. 2
\(^{361}\) IRC §643(a)(3)(B)
\(^{362}\) PLR 2002-21011, but see CCA 2006-44020, which did not permit to pay pecuniary bequest, because the trust did not “direct or require that the trustee pay the pecuniary legacies from Trust’s gross income.”
\(^{363}\) E.g. Ohio R.C. §5747.01(S), page 5 of instructions for Ohio Form IT-1041, Maine at 36 Me. Rev. Stat. §5163, §5164; with instructions at: www.maine.gov/revenue/forms/fiduciary/2010/10_1041ME_Gen%20Instructions.pdf
\(^{364}\) E.g., “If some of your itemized deductions have been phased out on your federal return due to federal adjusted gross income limitations, they must also be phased out on your Idaho return.” – Page 8 of Idaho income tax return instructions available at http://tax.idaho.gov/forms/EIN00046_10-21-2014.pdf. According to the Institute on Taxation and Economic Policy, twenty-six states generally follow the federal tax rules for itemized deductions (with exception of disallowing deduction for state income taxes paid) - Alabama, Arizona, Arkansas, Colorado, Delaware, Georgia, Idaho, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, South Carolina, Vermont and Virginia. Six jurisdictions follow federal rules, but with substantial further limitations: California, District of Columbia, Hawaii, New York, Utah & Wisconsin. E.g. see California’s additional phase out scheme at https://www.ftb.ca.gov/forms/2013/13_540.pdf. Ten states do not allow the federal itemized deductions at all: Connecticut, Illinois, Indiana, Massachusetts, Michigan, New Jersey, Ohio, Pennsylvania, Rhode Island and West Virginia. http://www.itepnet.org/pdf/pb52itemized.pdf
\(^{365}\) E.g., both Ohio and New York would indirectly allow a charitable deduction to a non-grantor trust because they start with taxable income, yet Ohio does not recognize charitable deductions for individuals and New York may limit itemized deductions to individuals to 25% or 50% based on income. See www.tax.ohio.gov, http://www.tax.ny.gov/pdf/2012/inc/it2011i_2012.pdf
independent of income tax consequences.” A mere ordering rule is insufficient, but we can accomplish advantageous results by creating limitations on lifetime limited powers of appointment (or spray powers) with such consequences. For instance, if the trust limits the charities’ potential distribution to gross income from net short-term capital gains, taxable interest and rents, it has the economic effect apart from income tax consequences because the amount that could be paid to the charity each year is dependent upon the amount of short term capital gains, taxable interest and rents the trust earns within that taxable year. Therefore, in our example, Barbara’s donor advised fund would not receive any long-term capital gains, qualified dividend or tax exempt income – the $20,000 would be limited to coming from the interest and short term capital gains. What a deal – the taxable beneficiaries can get the LTCG/QD eligible for 15%/0% brackets, while the charity gets the ordinary income otherwise taxed at up to 43.4%.

The IRS is surprisingly lenient when it comes to allocation of the charitable deduction when there are other non-charitable discretionary beneficiaries (i.e. not those entitled to “net income” or some variant). To return to our example of Barbara and her family bypass trust above, if the trustee (via spray or via Barbara or another party’s use of a lifetime LPOA) had donated $140,000 to charity from the trust’s gross income instead of $20,000 (assuming it was not limited to short term capital gains, interest and rents as postulated above), the result would be that Barbara or her family would have no taxable income from the trust, despite receiving substantial distributions from it.

Furthermore, a distribution pursuant to a lifetime limited power of appointment may also qualify for the IRC §642(c) deduction. In a recent PLR, the trust had this clause:

“[T]he Trustee shall distribute all or any portion of the trust estate, including both income and principal, as A may appoint, at any time and from time to time during A’s lifetime or upon A’s death, to any one or more organizations each of which is, at the time contemplated for an actual distribution to such organization, exempt from

366 Treas. Reg. §1.642(c)-3(b)(2)
367 Treas. Reg. §1.642(c)-3(b)(2), Example 1 shows mere ordering rules to be insufficient
368 Treas. Reg. §1.642(c)-3(b)(2) and Example 2, but proposed Regs under §1.1411-3 do not address whether this would equally apply for the surtax, see above. However, since most of the surtax follows subchapter J principals, there is a strong case that it should equally follow in this case to maximize the utility of the charitable deduction.
369 Treas. Reg. §1.662(b)-2, Example 1, specifically paragraph (e)
federal income taxation under § 501(a) as an organization described in § 501(c)(3) and also is described in §§ 170(c), 2055(a) and 2522(a).” (sic)

In this ruling, the IRS held that a distribution of gross income from the trust to one or more charitable organizations made pursuant to A’s limited power of appointment will be made “pursuant to the terms of the governing instrument” as provided in §642(c)(1) and provided that the other requirements of §642(c) are satisfied, such distribution from the trust will qualify for the charitable contribution deduction under §642(c). 370

What if the court, trustee, trust protector or parties, through reformation, decanting or non-judicial settlement, amend the governing instrument to allow the distribution? There is no reported case, but it seems logical under the statute that if this new agreement is now the valid governing instrument under state law, it should be allowed.

What if the trust has no provision to make distributions to charity, but an FLP/LLC partially owned by the trust makes the contribution from its gross income through its governing instrument, and the contribution passes to the trust via K-1? Surprisingly, the IRS will permit this as well, which also opens up further opportunities to exploit §642(c). 371

One unique aspect to §642(c) was not discussed in the PLRs, but merits attention. Most of the Subchapter J scheme taxing non-grantor trusts ignores tracing. For example, if the trust has $100,000 of income/DNI and distributes only Blackacre valued at $100,000 (and no assets traceable to income), the trust will get a deduction and the beneficiary will get a K-1 for $100,000 anyway. Such is not the case for §642(c) – the distribution must come from gross income, though it might come from income accumulated in a prior year. 372

This concept extends to distributions in kind. While the charitable contribution from a trust need not be in cash, any property must be traceable to gross income and basis may still be relevant. So, if the trust had purchased Blackacre for $80,000 (traceable to gross income) and Blackacre had appreciated to $100,000 by the time of distribution to charity, there is

370 PLR 2012-25004; similarly, PLR 2009-06008 allowed the 642(c) deduction through exercise of an LPOA
371 Rev. Rul. 2004-5. The ruling only addresses partnerships, but the rationale of the ruling would appear to extend to other pass through entities, such as estates, trusts, S corps or even a single member LLC
372 There is a good argument that the “gross income” is simply a quantitative limitation rather than requirement for tracing, see Federal Income Taxation of Fiduciaries and Beneficiaries, §412.8.3. (CCH 2009), by Byrle Abbin and Old Colony Trust Co. v. Commissioner, 301 U.S. 379 (1937). However, it is safest to assume in planning that sourcing is required, since at least one recent court requires it. Crestar Bank v. IRS, 47 F.Supp. 2d 670 (E.D. Va. 1999)
substantial uncertainty whether the deduction under IRC §642(c) is limited to $80,000, since only $80,000 came from gross income, or the full $100,000. The IRS believes that it should be limited to $80,000 – that unrealized capital gains should not be added to the deduction.\textsuperscript{373} However, the U.S. District Court for Western Oklahoma recently found the plain language of the statute dictated otherwise, and that the trustee is entitled to use the fair market value (which, of course, includes untaxed unrealized appreciation) for the §642(c) deduction.\textsuperscript{374}

Another hurdle is that the use of §642(c) is limited for ongoing business income. IRC §681 limits §642(c)’s deduction if the income would be unrelated business taxable income (UBTI) if it were in the hands of a tax exempt entity.\textsuperscript{375} If what would otherwise be UBTI goes to a public charity (not a private foundation), the trust may be able to offset 50% of the distribution.\textsuperscript{376} This rule is important to remember when administering a shark-fin or other grantor CLAT funded with closely held businesses if the grantor dies during the term. Since §642(c) is partly unavailable for offsetting UBTI-like income from an S corp, LLC, LP or other pass through entity running an active business, this may be another logical curtailing of the scope of a lifetime power of appointment or spray power to charity (see various sample language examples in appendix). Plus, it’s a reason to strongly reconsider private foundations as recipients of such income.

In short, with all the above tax planning ideas, we have the Holy Grail of income tax planning available to widows/widowers with bypass trusts – the ability to trap income in trust if state tax savings can be had, to spray income to lower bracket beneficiaries, and get above the line charitable deductions that can reduce the Medicare Surtax (including in many cases, state tax reductions even when states otherwise limit or deny such deductions). It can even be tailored in many cases to apply to the most highly taxed income!

The above income tax shifting techniques require that someone die or make taxable gifts to non-grantor trusts. What about the other 100% of the population that prefers to have tax savings before they die? This brings us to the last section.

\textsuperscript{372} IRS CCA Memo 2010-42023, while it is debatable, and there is now a district court holding otherwise, the memo is persuasive in its reasoning so don’t count on the same result as Green.
\textsuperscript{374} Green v. United States, 2015 U.S. Dist. LEXIS 151539 (W.D. Okla. 2015)
\textsuperscript{375} IRC §681(a), Treas. Reg. §1.642(c)-3(d) and (e)
\textsuperscript{376} Treas. Reg. §1.681(a)-2(a) and (b)(3) – it’s a convoluted statute, best understood reading examples in (c)
n. DINGs, NINGs, OINGs – Not just for STATE income tax advantage
(or, How to get a tax deduction for annual exclusion gifts to your kids)

Practitioners might consider not only embedding such strategies into bypass trusts, but in some cases might actively use such flexible provisions in intervivos irrevocable non-grantor trusts for better income tax planning (both state and federal). For example, the recently resurrected DING strategy used to avoid state income tax should include such clauses, and those with charitable intent who already have substantial charitable carryforwards may get more bang for the buck using a non-grantor CLT or non-grantor trust with §642(c) provisions that does not qualify as a CLT instead of a CRT or grantor CLT.377

Let’s start with a DING example that does not even rely on state income tax savings.378 John and Mary are newly retired and well off, but not “rich”. They no longer worry about estate tax. They have $1 million in real estate, $3 million in retirement plans, and $5 million in various stocks, bonds, and funds. They are wealthy enough, and generous enough, however, to make approximately $50,000 in annual exclusion gifts to their two children, who have young children themselves, and typically give about $30,000 annually to various charities. They get no tax deduction for gifting to their children, no state income tax deduction for their gifts to charity, and their charitable deduction is somewhat “phased out” under the Pease limitations and cannot be used to offset the new 3.8% Medicare surtax. Let’s say their taxable income is under $400,000, putting them in a 35% federal bracket, 5.41% Ohio, 15% capital gains, plus 3.8% surtax for net investment income other than IRA distributions, etc.

What if they moved $2 million of their non-IRA investments to a DING trust? Aside from better asset protection, let’s flesh out how what happens for income tax under the above scenario if the same distributions are made from a DING trust instead of from John and Mary directly. Assume the $2 million in trust makes 2% taxable interest, 2% dividends, 1% capital gain (we’ll ignore any unrealized capital gains/losses) = $40,000 interest, $40,000

378 I refer to “DINGs” or Delaware Incomplete Gift Non-Grantor Trusts throughout this paper for simplicity and since the early PLRs used DE law, but you can also establish INGs in other states. E.g. NV (NRS §166.040(2)(b), OH (Ohio R.C. §5816.05(C)), SD (S.D. Cod. Laws §15-16-2(2)(b) and DE (12 Del. Code §3570(11)(b)(2) all specifically permit a settlor to retain lifetime LPOAs, which were a factor in the recent ING PLRs. Not all do.
dividends, $20,000 capital gain. Thus, at the most basic level, John and Mary have shifted $100,000 of taxable income from their personal Form 1040, to the Form 1041 of the trust.

When the trustee distributes the $80,000 to the children and charity, this completes the taxable gift, but the gift will qualify for the annual exclusion and/or charitable exclusion. The trust will get an above the line deduction, for federal (and usually state, as discussed above) tax purposes for the charitable contribution. If two children make $45,000 and $100,000 respectively, the K-1 for the qualified dividends distributed to them will be taxed at 0% and 15% respectively, not 18.8% (lowering the overall tax to the family on the $40,000 of qualified dividends from $7,520 to $3,000, plus more if the children live in a state with lower taxes than Ohio). The $10,000 of interest K-1’d to the children changes tax on that from 38.8% plus 5.41% Ohio to 15% plus approx. 4% state – cutting that tax by more than half as well. The charitable contribution is more advantageous as well – avoiding 3.8% Medicare and 5.41% Ohio tax on the $30,000, not to mention the Pease limitations, so there is another $3,000 or so benefit there.\(^{379}\) Not only that but many taxpayers, even many higher income taxpayers, do not even itemize deductions.\(^ {380}\)

Would a family bother with a trust to get $10,000 tax savings annually? Perhaps. The higher the donor’s bracket, the larger the gifts, the lower the donee’s bracket = more savings. It’s likely that only wealthier taxpayers in the top tax bracket would utilize this, so the savings in the above example would then be a bit higher, adding 4.6% to the arbitrage (35% -> 39.6%).

**State Income Taxation of Trusts – DING Savings**

Of course, the above example does not even contemplate potential state income tax savings, which is touted as the primary benefit of DINGs. This paper will not discuss dozens of states’ income tax laws – see the various compiled state charts.\(^ {381}\) These charts are an excellent starting point for your state research, but do not go into every nuance or discuss “source income” limitations, which are crucial for closely held businesses/real estate.

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\(^{379}\) Pease limitations do not apply to non-grantor trusts and estates. IRC §68(e)

\(^{380}\) According to one study of 2010 tax return data, of those in 15% bracket, only 37% itemize, of those in 25% bracket, only 65% itemize, of those in 33% bracket, only 70%, rising to 90% for those in the top bracket. See [http://www.urban.org/uploadedpdf/1001486-Who-Itemizes-Deductions.pdf](http://www.urban.org/uploadedpdf/1001486-Who-Itemizes-Deductions.pdf). If your client has paid off their mortgage, for example, and no longer pays local income tax (or perhaps no state), this becomes more likely.

\(^{381}\) E.g. *CCH Multistate Guide to Trusts and Trust Administration*, Jeffrey A. Schoenblum, or various CLEs from Richard Nenno, such as *Planning to Minimize or Avoid State Income Tax on Trusts*, 34 ACTEC L.J. 131 (2008), my own charts have additional important factors not addressed in those, i.e. source income rules.
o. The DING-CRUT

Corporate mergers and tax inversions are the hot topic du jour. These inversions typically trigger gain on the merger if it goes through, even if the client/prospect does not want to sell (despite some articles claiming that this or Donald Sterling’s forced sale is akin to a "condemnation" - which is complete nonsense likely to end up with a tax fraud charge).

Most readers are familiar with using charitable remainder trusts ("CRTs") to defer taxation - the CRT itself is tax exempt, but payments back to a settlor/grantor will be taxable under a 4 tier ordering system, so it's more accurate to say that it defers rather than avoids the tax (provided the beneficiary lives long enough to receive enough back, if it is a lifetime CRUT). So, CRUTs are often recommended to defer gains on an anticipated sale (as long as the transfer is done before it is a “done deal”).

DINGs often cannot get around "source" income (in-state real estate, closely held in-state LLC/LP/S corps). However, publicly held C corps like AbbVie, Burger King, etc are not source income to any one state. Taxation of the sale of such stocks (and depending on the state, often pure stock sales of LLCs/S corporations as well) typically follow the domicile of the owner, under the legal theory of mobilia sequuntur personam. Thus, these mergers create a perfect candidate for using either DING trusts to avoid state income tax for higher bracket taxpayers, or CRUTs to defer federal tax. Or both.

CRUTs can be combined with a DING to defer the federal taxation until payment, avoid state taxation of the payment and even permit more optimal tax shifting and charitable deductions for any shifting of the subsequent payment. The DING can be the beneficiary of the CRUT. There is no prohibition on a non-grantor trust or other entity being an income beneficiary of a CRT. This would have to be a term, not lifetime, CRUT, of up to 20 years.

This may allow the best of both worlds - defer the federal tax, and avoid the state income tax. In contrast to a term CRT naming a child/grandchild as beneficiary, which creates a lump sum taxable gift upon creation, this method could use the annual exclusion for any annual gifts coming from the DING to the children.

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382 For timing of transfers and assignment of income doctrine, see Rev. Rul. 78-197 discussion and acquiescence to Palmer v. Commissioner, 62 T.C. 684 (1974), aff'd on another issue, 523 F.2d 1308 (8th Cir. 1975)
383 IRC §7701(a) for definition of “person” – equally, e.g., an S corporation might establish and be a beneficiary of a charitable remainder trust. See IRC §664(d) for basic CRAT and CRUT definitions that include “persons".
Even more intriguing, a CRUT can be the beneficiary of the DING, or more accurately, a CRUT can be a permissible appointee receiving funds by direction from the distribution committee’s lifetime limited power of appointment.

This enables much more efficient tax deferral than an ordinary CRUT. For more details on this technique, see the author’s separate material and presentations on this subject. Consider the following chart which illustrates the potential effect over 21 years of several tax planning techniques involving the sale of a $10 million property with $4 million basis, half of the gain being 1250 recapture, with subsequent post-sale return on investment net of expenses of 7.5%, using a CRUT with a minimized charitable interest (approx. 10%), state income tax rate of 9.9% and top federal rates of 20% LTCG. 25% 1250 recapture and 3.8% net investment income tax.
IX. Conclusion - Pros and Cons of the Optimal Basis Increase and Tax Efficiency Trust

Much of the planning and techniques for the über-wealthy are unchanged after ATRA – the increased exclusion amounts merely turbocharge previous gifting techniques. The Optimal Basis Increase Trust techniques discussed in Part III won’t help a wealthy couple with $100 million a bit, but they can be extremely valuable for sub-$10.5 million estates.

The ongoing trust income tax planning techniques discussed in Part VIII apply to all estate levels – even more so for wealthier families. After all, how many lower generation trust beneficiaries, even of wealthy families, always make over $400,000 or $450,000 in taxable income and are subject to the same tax rates as a non-grantor trust?\(^{384}\) Even those rare wealthy families whose children/grandchildren/great-grandchildren all make over $450,000 in taxable income are often charitably inclined and should be considering the varied §642(c) techniques discussed herein.

For married clients with estates under approximately $10.5 million, the Optimal Basis and Income Tax Efficiency Trust offers the following advantages over an outright bequest, even where DSUE is successfully claimed: better asset protection from creditors, better divorce/remarriage protection, better protection from mismanagement, better sheltering of appreciation/growth from both federal and state estate and inheritance taxes, better planning in event of simultaneous or close death (potentially millions in savings for those estates where one spouse’s estate is over $5.25 million), better use of GST exclusion, better incapacity planning, better Medicaid/VA/benefits planning, avoidance of step down in basis at second death and the ability to spray income to children/charities in lower brackets. The drawbacks are the same as with any trust planning: increased attorney fees (and potentially post-mortem, accounting/trustee fees) and complexity. The §678(a) variant discussed in Part VIII may even alleviate some of the accounting/tax filing complexity.

The Optimal Basis and Income Tax Efficiency Trust offers the following advantages over the traditional bypass trust: better step up in basis at second death (potentially for fractional interests held w/survivor outright as well as trust), better compatibility with disclaimer

\(^{384}\) Thresholds for single/married filing jointly couples to incur the top 39.6% and 20% long-term capital gains and qualified dividends rates. See IRC §1 – those adjust for inflation. If someone has $100,000 of itemized deductions, that threshold may approximate $500,000/$550,000 AGI, since taxable income is calculated after the standard or itemized deductions, exemptions.
planning at first death, enabling disclaimer planning at second death, better ongoing income
tax treatment for the trust and spouse overall and better income tax flexibility and charitable
deduction treatment via spray provisions or lifetime limited powers of appointment.

The Optimal Basis and Income Tax Efficiency Trust offers the following advantages over
a traditional QTIP (assuming estates under exclusion amount): better asset protection during
the surviving spouse’s life (for accounting income), better leverage of GST exclusion than
reverse QTIP if income is reinvested (though in some instances, QTIPs are more GST efficient),
less complicated administration/compliance for retirement plan/IRA benefits,\textsuperscript{385} better ability
to augment or curtail powers of appointment, less chance of losing ported DSEU exclusion due
to remarriage, better ongoing income tax treatment for the primary beneficiary, ability to
spray income or capital gains to lower (or 0%) tax bracket beneficiaries, ability to spray or shift
income with better charitable deductions up to 100% of trust AGI with no Pease limitations
and a one-year lookback, ability to gift or transact with the trust without the IRC §2519 gift tax
trap, ability to shelter from 16%-20% state estate/inheritance tax, ability to better avoid
inadvertent discounting for fractional interests, no requirement to file (or chance to botch)
Form 706 to make appropriate QTIP election, no prospect of the IRS using a Rev. Proc. 2001-
38 argument to deny the effect of the election, better ability to decant/amend, ability to do
disclaimer planning nine months from the surviving spouse’s death and the prevention of a
second step down in basis.

Just as importantly, although not extensively discussed herein, if the surviving spouse’s
estate, including the QTIP trust, increases over time above the survivor’s Applicable Exclusion
Amount (including portability), the bypass trust will almost certainly have saved more in
estate taxes than the potential capital gains tax savings from getting new (presumably mostly
increased) basis.\textsuperscript{386} With many people expecting inflation to eventually increase with the

\textsuperscript{385}QTIPs require spousal net income access/payout from trust AND from IRA/QP owned by trust. Rev. Rul.
2006-26. This makes them “leakier” and wastes GST exemption if QTIP is GST exempt. This creates more
problems administratively, since non-professional trustees do not understand this, especially if inflation reignites
such that internal IRA accounting income becomes likelier to exceed RMDs – could an Atkinson style attack by
the IRS based on improper administration retroactively destroy a QTIP just like a CRT? See Atkinson v.
Commissioner, 309 F.3d 129 (11th Cir. 2002) and CCA 2006-28026, both holding that impeccably drafted but
improperly administered CRTs can be disqualified – even if the charity is only helped, not harmed in any way.

\textsuperscript{386}For illustrations of this savings if investment returns net 11% and the surviving spouse lives 15 or 30 more
years, see Gassman, Crotty, Buschart & Moody \textit{On the $28,000,000 Mistake: Underestimating the Value of a}
recently expanded money supply (quantitative easing), realize that higher inflation over time exacerbates this extensively, since the locked in DSEU amount does not adjust for inflation. And remember, the first to die’s family (QTIP) usually gets stuck with the tax apportionment – important for blended families.\textsuperscript{387}

There are some narrow situations in which a marital trust will generate better estate tax results than an OBIT.\textsuperscript{388} There are also situations in which a marital trust will generate a better overall basis increase – consider two spouses who each have net $5 million estates and one survives by only two years, all assets mildly appreciate with inflation to $10.5 million total, and the spouse doesn’t spray any income to lower bracket beneficiaries from the trust - the OBIT would not save any estate tax, not save any income tax, would only garner very minimal if any step up, whereas a QTIP (if portability elected and DSUE not lost) would not cost any estate tax and would garner slightly more step up in basis.

To craft a precise rule, you need to know asset mix, depreciation info, date of 2\textsuperscript{nd} death, the beneficiary’s distribution needs and whether a powerholder would spray income, tax rates/exclusions (including state), inflation, investment turnover, investment returns and more to make an accurate prediction. QTIPs used with portability have a sweet spot similar to the example above (total assets close to combined exclusion but little chance of eventual estate tax), but with similar or larger estates OBITs could save a lot more estate tax if the surviving spouse lives a significant time with returns outpacing inflation, and with smaller estates an OBIT can get the exact same step up AND avoid step down.

But basis increase (or lack of decrease) for the family at the surviving spouse’s death is a one-time event and even these benefits are typically delayed until sale. This is probably not nearly as important to the surviving spouse as the ongoing income tax efficiency of the trust.

\textsuperscript{387} Discussed in Part I, see IRC §2207A and your state equivalent, such as Ohio R.C. §2113.86(I).

\textsuperscript{388} For the wealthy, a QTIP bequest with full DSUEA elected and reverse QTIP election would nearly always beat a standard bypass trust if the surviving spouse then immediately fully funded via gift an irrevocable grantor trust (or released a portion of the QTIP to trigger IRC §2519). This could then exploit installment sales, swaps, etc. Using grantor trusts funded via gift after the first death enable the use of pre-estate tax dollars to pay the income tax burden of the grantor trust. Most wealthy couples will have already funded irrevocable grantor trusts during their lifetimes, but those who haven’t should strongly consider that technique (a typical OBIT could, of course, be converted to a QTIP if powers disclaimed/released and timely election made – see Clayton QTIP discussion p. 9).
It is here that the Optimal Basis Increase and Income Tax Efficiency Trust offers the most flexibility, control and efficiency to optimize tax benefits long-term – all of the benefits of the traditional bypass trust but with avoidance of most of the drawbacks. Whereas a bypass or OBIT can be amended in various ways, a marital trust has to be careful to curb any such amendment powers, else the marital deduction will be denied (and hence, the subsequent step up). 389 We have to tread carefully with post mortem amendments to marital (or charitable) trusts.

As discussed, using the Delaware Tax Trap to maximize basis in some circumstances is safer and can be more targeted than using a formula GPOA, but both can probably be used effectively (especially if no cap is needed for smaller estates). However, unlike general powers which have ample precedent and guidance, there is only one reported case construing the Delaware Tax Trap. The best of all worlds would be to utilize state law that clearly allows triggering the Delaware Tax Trap by creating successive limited powers of appointment.

There will certainly be certain situations in which some of these techniques should not be used. Qualified retirement plan/IRA assets receive longer tax deferral if left outright to a spouse, for example, so in some cases using portability for such assets can be a good plan. We can certainly think of others, but many taxpayers will prefer variations of some of these income tax planning techniques. 390

Many taxpayers have been reticent to pay attorneys for needed amendments to planning due to “tax volatility fatigue” and frustration with Congress. The pitfalls of the status quo and the techniques discussed in this article, coupled with apparent permanency, should give substantial financial incentives for clients to revisit their old estate plan. These techniques are not available to “do it yourselfers” or general practitioners – there are no off-the-shelf, Nolo Press, Trusts-R-Us or other online form books for any of this. However, any attorney specializing in estate planning can easily adapt these ideas to provide tremendous value to their clients.

389 This is why most decanting statutes specifically exclude marital trusts and trust protector/amendment provisions had better do the same – see PLR 9525002 for a cautionary tale of good intentions gone awry.
390 E.g., would giving the surviving spouse the power to appoint equally to a trust for settlor’s children from prior marriage which grants them a presently exercisable general power of appointment be all that different from a default clause that pays to them outright? Would a spouse holding a formula general power really appoint to creditors to spite remaindermen and would the chosen non-adverse party conceivably consent to that?
Speaker Bio

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As one of Key’s national wealth specialists, Ed works with local Key Private Bank wealth management teams nationwide, advising high net worth clients on how to preserve and transfer their wealth. Ed has been with Key since 2005. He was previously in private law practice in Cincinnati and Springboro, Ohio concentrating in taxation, probate, estate and business planning. Other experience includes drafting court opinions for the U.S. District Court of Portland, Oregon as a law clerk. Ed is recent outgoing Chair of the Dayton Bar Association’s Estate Planning, Trust and Probate Committee. He is married and resides in Springboro, Ohio with his wife and two daughters.

Education:
• Bachelor of Arts (B.A.), History, Stetson University
• Juris Doctorate (J.D.), Northwestern School of Law at Lewis & Clark College
• Masters of Law (LL.M.) in Tax Law, Capital University Law School
• Masters of Business Administration (MBA), Xavier University

Professional Accreditations:
• Licensed to practice in all Ohio courts, U.S. District Court of Southern Ohio and U.S. Tax Court
• Certified Specialist through Ohio State Bar Assn in Estate Planning, Trust and Probate Law
• Certified Financial Planner (CFP®), Registered Financial Consultant (RFC®)
• Non-Public Arbitrator for the Financial Industry Regulatory Authority (FINRA)

Recent Speaking Engagements and Published Articles:
• Speaker, 2013, Ohio State Bar Association Annual Conference on Wealth Transfer Planning, Asset Protection and the Ohio Legacy Trust, Optimal Basis Increase Planning
• Author, The Optimal Basis Increase Trust, Leimberg Information Services, March 2013
• Author, Optimizing Trusts to Avoid the New Medicare Surtax, Trusts and Estates, Dec. 2012
• Speaker, 2012 American Bar Assn Tax Section Meeting; Estate Planning for Large Retirement Plans
• Speaker, 2011 Purposeful Planning Institute and 2011 SFSP Annual Tax Symposium, Exploiting Asset Protection and Tax Planning Opportunities after the 2010 Tax Act
• Speaker, 2010 Ohio Wealth Counsel CLE: Advanced Asset Protection Planning
• Speaker, 2009 Dayton Bar Association CLE, Protecting Trust Assets from Tax Liens
• Author, Trusteed IRAs: An Elegant Estate Planning Option, September 2009 Trusts and Estates
• Co-Author, Ensuring the Stretch, July/August 2007 issue of Journal of Retirement Planning
• Author, Using Separate or Standalone Trusts as Qualified Plan/IRA Beneficiaries, Sept/Oct 2007 issue of Journal of Retirement Planning
Powers of Appointment


(a) In general

The value of the gross estate shall include the value of all property—

(1) Powers of appointment created on or before October 21, 1942

To the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent’s gross estate under sections 2035 to 2038, inclusive. For purposes of this paragraph (2), the power of appointment shall be considered to exist on the date of the decedent’s death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent’s death notice has been given or the power has been exercised.

(3) Creation of another power in certain cases [aka the Delaware Tax Trap]

To the extent of any property with respect to which the decedent—

(A) by will, or

(B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent’s gross estate under section 2035, 2036, or 2037,

exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

(b) Definitions

For purposes of subsection (a)—

(1) General power of appointment

The term “general power of appointment” means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that—

(A) A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.

(B) A power of appointment created on or before October 21, 1942, which is exercisable by the decedent only in conjunction with another person shall not be deemed a general power of appointment.

(C) In the case of a power of appointment created after October 21, 1942, which is exercisable by the decedent only in conjunction with another person—

(i) If the power is not exercisable by the decedent except in conjunction with the creator of the power—such power shall not be deemed a general power of appointment.

(ii) If the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent—such power shall not be deemed a general power of appointment. For the purposes of this clause a person who, after the death of the decedent, may be possessed of a power of appointment (with respect to the property subject to the decedent’s power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the decedent’s power.

(iii) If (after the application of clauses (i) and (ii)) the power is a general power of appointment and is exercisable in favor of such other person—such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of such persons (including the decedent) in favor of whom such power is exercisable.

For purposes of clauses (ii) and (iii), a power shall be deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate.

(2) Lapse of power

The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:

(A) $5,000, or

(B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.
26 U.S.C. §1014 (bold, italics and [brackets] added by author)

(a) **IN GENERAL** Except as otherwise provided in this section, 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, if not sold, exchanged, or otherwise disposed of before the decedent’s death by such person, be—

(1) the fair market value of the property at the date of the decedent’s death,

(2) in the case of an election under section 2032, its value at the applicable valuation date prescribed by such section,

(3) in the case of an election under section 2032A, its value determined under such section, or

(4) to the extent of the applicability of the exclusion described in section 2031(c), the basis in the hands of the decedent. [this is the additional exclusion provision for qualified conservation easements]

(b) **PROPERTY ACQUIRED FROM THE DECEDENT** For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

(1) Property acquired by bequest, devise, or inheritance, or by the decedent’s estate from the decedent;

(2) Property 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 revoke the trust;

(3) In the case of decedents dying after December 31, 1951, property 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;

(4) Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;

(5) In the case of decedents dying after August 26, 1937, and before January 1, 2005, property acquired by bequest, devise, or inheritance or by the decedent’s estate from the decedent, if the property consists of stock or securities of a foreign corporation, which with respect to its taxable year next preceding the date of the decedent’s death was, under the law applicable to such year, a foreign personal holding company. In such case, the basis shall be the fair market value of such property at the date of the decedent’s death or the basis in the hands of the decedent, whichever is lower;

(6) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse’s one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the
United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent’s gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;


(9) In the case of decedents dying after December 31, 1953, 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. In such case, if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent. Such basis shall be applicable to the property commencing on the death of the decedent. This paragraph shall not apply to—

(A) annuities described in section 72;

(B) property to which paragraph (5) would apply if the property had been acquired by bequest; and

(C) property described in any other paragraph of this subsection.

(10) Property includible in the gross estate of the decedent under section 2044 (relating to certain property for which marital deduction was previously allowed). In any such case, the last 3 sentences of paragraph (9) shall apply as if such property were described in the first sentence of paragraph (9).

(c) PROPERTY REPRESENTING INCOME IN RESPECT OF A DECEDENT

This section shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

(d) SPECIAL RULE WITH RESPECT TO DISC STOCK

If stock owned by a decedent in a DISC or former DISC (as defined in section 992(a)) acquires a new basis under subsection (a), such basis (determined before the application of this subsection) shall be reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date. In computing the gain the decedent would have had if he had lived and sold the stock, his basis shall be determined without regard to the last sentence of section 996(e)(2) (relating to reductions of basis of DISC stock). For purposes of this subsection, the estate tax valuation date is
the date of the decedent’s death or, in the case of an election under section 2032, the applicable valuation date prescribed by that section.

(g) **APPRECIATED PROPERTY ACQUIRED BY DECEDENT BY GIFT WITHIN 1 YEAR OF DEATH**

(1) **IN GENERAL** In the case of a decedent dying after December 31, 1981, if—

(A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent’s death, and

(B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

(2) **DEFINITIONS** For purposes of paragraph (1)—

(A) **Appreciated property**

The term “appreciated property” means any property if the fair market value of such property on the day it was transferred to the decedent by gift exceeds its adjusted basis.

(B) **Treatment of certain property sold by estate**

In the case of any appreciated property described in subparagraph (A) of paragraph (1) **sold** by the estate of the decedent or by a trust of which the decedent was the grantor, rules similar to the rules of paragraph (1) shall apply to the extent the donor of such property (or the spouse of such donor) **is entitled to the proceeds from such sale**.

(f) **BASIS MUST BE CONSISTENT WITH ESTATE TAX RETURN** For purposes of this section—

(1) **IN GENERAL** The basis of any property to which subsection (a) applies shall not exceed—

(A) in the case of property the final value of which has been determined for purposes of the tax imposed by chapter 11 on the estate of such decedent, such value, and

(B) in the case of property not described in subparagraph (A) and with respect to which a statement has been furnished under section 6035(a) identifying the value of such property, such value. [this refers to the new beloved Form 8971]

(2) **EXCEPTION**

Paragraph (1) shall only apply to any property whose inclusion in the decedent’s estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate.

(3) **DETERMINATION** For purposes of paragraph (1), the basis of property has been determined for purposes of the tax imposed by chapter 11 if—

(A) the value of such property is shown on a return under section 6018 and such value is not contested by the Secretary before the expiration of the time for assessing a tax under chapter 11,
(B) in a case not described in subparagraph (A), the value is specified by the Secretary and such value is not timely contested by the executor of the estate, or 
(C) the value is determined by a court or pursuant to a settlement agreement with the Secretary.

(4) Regulations
The Secretary may by regulations provide exceptions to the application of this subsection.

Treasury Regulation § 1.1014-1 Basis of property acquired from a decedent.

(a) General rule. The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death, or, if the decedent's executor so elects, at the alternate valuation date prescribed in section 2032, or in section 811(j) of the Internal Revenue Code of 1939. Property acquired from a decedent includes, principally, property acquired by bequest, devise, or inheritance, and, in the case of decedents dying after December 31, 1953, property required to be included in determining the value of the decedent’s gross estate under any provision of the Internal Revenue Code of 1954 or the Internal Revenue Code of 1939. The general rule governing basis of property acquired from a decedent, as well as other rules prescribed elsewhere in this section, shall have no application if the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent. For general rules on the applicable valuation date where the executor of a decedent's estate elects under section 2032, or under section 811(j) of the Internal Revenue Code of 1939, to value the decedent's gross estate at the alternate valuation date prescribed in such sections, see paragraph (e) of §1.1014-3.

(b) Scope and application. With certain limitations, the general rule described in paragraph (a) of this section is applicable to the classes of property described in paragraphs (a) and (b) of §1.1014-2, including stock in a DISC or former DISC. In the case of stock in a DISC or former DISC, the provisions of this section and §§1.1014-2 through 1.1014-8 are applicable, except as provided in §1.1014-9. Special basis rules with respect to the basis of certain other property acquired from a decedent are set forth in paragraph (c) of §1.1014-2. These special rules concern certain stock or securities of a foreign personal holding company and the surviving spouse's one-half share of community property held with a decedent dying after October 21, 1942, and on or before December 31, 1947. In this section and §§1.1014-2 to 1.1014-6, inclusive, whenever the words property acquired from a decedent are used, they shall also mean property passed from a decedent, and the
phrase *person who acquired it from the decedent* shall include the *person to whom it passed from the decedent*.

**c) Property to which section 1014 does not apply.** Section 1014 shall have no application to the following classes of property:

1. Property which constitutes a right to receive an item of income in respect of a decedent under section 691; and

2. Restricted stock options described in section 421 which the employee has not exercised at death if the employee died before January 1, 1957. In the case of employees dying after December 31, 1956, see paragraph (d)(4) of § 1.421-5. In the case of employees dying in a taxable year ending after December 31, 1963, see paragraph (c)(4) of § 1.421-8 with respect to an option described in part II of subchapter D.
Glossary of Terms

“Power of appointment” – a power that enables the donee of the power (powerholder), acting in a non-fiduciary capacity, to designate recipients of beneficial ownership interests in the appointive property.

“Donor” – the person who created the power of appointment.

“Donee” – the person on whom the power is conferred and who may exercise the power. However, I prefer to use the term “Powerholder” to avoid confusion.

“Permissible appointees” – the persons for whom the power may be exercised to benefit

“Appointee” – a person (or entity/trust) to whom an appointment has been made.

“Taker in default” – person(s) who would receive property if power is not exercised.

“General Power of Appointment” (“GPOA”) – a power exercisable in favor of the donee (powerholder), the powerholder’s estate, the powerholder’s creditors or the powerholder’s estate. For tax definition, see IRC §2041/2514.

“Limited, (aka Non-general) Power of Appointment” (“LPOA”) – any power that is not a general power of appointment. Some also use the term “special power of appointment”, a narrower subset of LPOAs – I will use “limited power of appointment” throughout this outline.

“Presently exercisable general power of appointment” – sometimes referred to as a “PEG power”, is a power that permits the powerholder to exercise it with effect during their lifetime, as opposed to a testamentary power, exercisable and effective only at death.

“Testamentary LPOA or GPOA” – a power that is exercisable only at death, whether by will, trust or other writing (often referred to as by “deed”, even though not recorded)

“Power Trust” – a trust in which the settlor grants a lifetime limited power of appointment in someone other than themselves, and the permissible appointees of the power include the settlor. This is not a universally accepted term, but I could not think of a better acronym or abbreviation for it. See other asset protection CLE materials by author on this topic.

391 Many paraphrased from Restatement of Property, Donative Transfers, 2nd and 3d – see §17.1 et seq.
**Appendix of Sample Clauses, Letters, Charts, Infographics**

“With regard to excellence, it is not enough to know, but we must try to have and use it.”
- **Aristotle, Nichomachean Ethics**

“It is not the critic who counts; not the man who points out how the strong man stumbles, or where the doer of deeds could have done them better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood; who strives valiantly; who errs, who comes short again and again, because there is no effort without error and shortcoming; but who does actually strive to do the deeds; who knows great enthusiasms, the great devotions; who spends himself in a worthy cause; who at the best knows in the end the triumph of high achievement, and who at the worst, if he fails, at least fails while daring greatly, so that his place shall never be with those cold and timid souls who neither know victory nor defeat.” — **Theodore Roosevelt**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Formula testamentary GPOA with ordering rules, non-adverse party consent</td>
<td>A-1</td>
</tr>
<tr>
<td>2</td>
<td>Formula testamentary GPOA tracking GST exclusion available</td>
<td>A-10</td>
</tr>
<tr>
<td>3</td>
<td>Simple formula GPOAs without ordering rule</td>
<td>A-13</td>
</tr>
<tr>
<td>4</td>
<td>Additional Language to cap a testamentary GPOA in the event a Power Holder’s estate is substantially insolvent</td>
<td>A-14</td>
</tr>
<tr>
<td>5</td>
<td>Exercise of testamentary LPOA to trigger Delaware Tax Trap</td>
<td>A-15</td>
</tr>
<tr>
<td>6</td>
<td>Sample language to retain LPOA in disclaimer funded trust</td>
<td>A-16</td>
</tr>
<tr>
<td>7</td>
<td>Infographic and language Tax Shifting of Inherited Retirement Plan Distributions</td>
<td>A-17</td>
</tr>
<tr>
<td>8</td>
<td>Sample partial release where LPOA retained in disclaimer funded trust</td>
<td>A-19</td>
</tr>
<tr>
<td>9</td>
<td>Sample lifetime limited power of appointment (including charities w/limit)</td>
<td>A-21</td>
</tr>
<tr>
<td>10</td>
<td>Sample language for including various capital gains as part of DNI distribution</td>
<td>A-25</td>
</tr>
<tr>
<td>11</td>
<td>Proposed statute for opt-in Delaware Tax Trap triggering for broad LPOAs</td>
<td>A-26</td>
</tr>
<tr>
<td>12</td>
<td>Decanting a discretionary trust to add a narrow GPOA or LPOA</td>
<td>A-27</td>
</tr>
<tr>
<td>13</td>
<td>Notice to beneficiaries of decanting to trust with LPOA/GPOA (Ohio)</td>
<td>A-30</td>
</tr>
<tr>
<td>14</td>
<td>Decanting a non-discretionary trust <em>(HEMS)</em> to add a narrow LPOA/GPOA</td>
<td>A-31</td>
</tr>
<tr>
<td>15</td>
<td>Checklist for Existing Irrevocable Trusts for Opportunities to Step Up Basis</td>
<td>A-34</td>
</tr>
<tr>
<td>16</td>
<td>Forfeiture provision added to spendthrift, with carve out for QSST, IRA/678a</td>
<td>A-36</td>
</tr>
<tr>
<td>17</td>
<td>Sample alternate disposition clause to save exclusion if DSUE/706 botched</td>
<td>A-37</td>
</tr>
<tr>
<td>18</td>
<td>Formula GPOA for GST Non-Exempt Trust for GST v. Estate tax efficiency</td>
<td>A-38</td>
</tr>
<tr>
<td>19</td>
<td>Spousal Waiver for certain irrevocable trusts</td>
<td>A-39</td>
</tr>
<tr>
<td>20</td>
<td>Sample provision in Will to Exercise POA</td>
<td>A-40</td>
</tr>
<tr>
<td>21</td>
<td>Infographic one-pager – Will Your Old AB Trust Cost You Income Tax?</td>
<td>A-41</td>
</tr>
<tr>
<td>22</td>
<td>Infographic one-pager – Will Your Old LLC Cost your Family Income Tax?</td>
<td>A-42</td>
</tr>
<tr>
<td>23</td>
<td>Comparison Chart – Various Trust Options to Avoid Trapping Income in Trust</td>
<td>A-42</td>
</tr>
<tr>
<td>24</td>
<td>Comparison Chart – DAPT v. Lifetime (LLPOA) Trust Design Options</td>
<td>A-42</td>
</tr>
<tr>
<td>25</td>
<td>Comparison Chart – Strategies for Step Up at First Death for Couples</td>
<td>A-42</td>
</tr>
<tr>
<td>26</td>
<td>Comparison Chart – Strategies to Achieve Step Up at 2nd Spouse’s Death for Pre-Existing Bypass Trusts</td>
<td>A-42</td>
</tr>
<tr>
<td>27</td>
<td>Comparison Chart - Various Basic Trust Design Options for Married Couples</td>
<td>A-42</td>
</tr>
</tbody>
</table>
**WILL YOUR $1 MILLION LLC COST YOUR FAMILY $167,169 IN ADDITIONAL INCOME TAXES?**

**Problem:**
Over 90% of LLC Agreements have not been amended and adapted to the tremendous income & estate tax changes since 2013.

For single taxpayers with under $5.43 million estates and married taxpayers with under $10.86 million estates, the design of LLC provisions should often be quite different from those with larger estates.

**Typical life cycle of family LLC owning a $1 million rental property (same concepts apply to businesses or other assets):**

<table>
<thead>
<tr>
<th>LLC with $1 million property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Husband and wife own 50/50</td>
</tr>
<tr>
<td>Basis is now $400,000 each.</td>
</tr>
</tbody>
</table>

| Husband dies, 50% goes |
| Bypass or QTIP Trust for wife |
| Valuation of 50% LLC interests discounted 15-70%. Assume 30% |

| Trust’s 50% LLC interest is 30% discounted, so the basis is only $350,000 FMV, not $500,000. |
| ** in community property state, Wife’s basis also stepped down. |

**10 years pass** after Husband’s death, property value has doubled by Wife’s death. More tax may be paid **every year** due to lost inside basis/depreciation if LLC makes or had made a Section 754 election.

| Rental property now FMV $2 million. Basis $750,000 (or $700,000 CP) – 10 yrs deprec. |
| Wife owns 50% outright and 50% is owned by AB Trust |

| Wife dies. 50% LLC owned outright is valued at discount |
| 50% LLC in trust gets no step up if in bypass trust, step up w/ valuation discount if in QTIP |

| 50% LLC owned by wife only “stepped up” to $700,000 basis |
| Basis 50% LLC owned by a QTIP would be the same -$700,000, if bypass, $350,000-depreciation |

After Wife’s death, children inherit $2 million LLC property, but NOT $2 million basis, causing them to incur more ongoing income tax than if optimal basis clauses used.

| Children sell property for $2 million w/ $1.4 million basis (or < $1 million if 50% inherited from bypass). Incur $600,000 capital gain. |
| Children pay $167,169 LTCG Tax if 50% from QTIP, or $278,614 LTCG tax if 50% inherited from bypass, (*Ohio residents, itemizers, no Pease limit/AMT) |

**So What?**
Keeping the status quo with old-style LLC and Trust Agreements may cost the surviving spouse and/or other beneficiaries hundreds of thousands of dollars in ordinary income tax (if assets are comprised of depreciable property), and/or significant capital gains tax when assets are sold, due to IRS mandated valuation “discounts”.

**The Solution:**
We can maximize these discounts for estates that would otherwise be subject to estate tax, but eliminate this discount for smaller estates in order to increase basis and lower income tax. LLCs and trusts can be adapted to exploit the new tax law changes to maximize basis increase for those without taxable estates, and maximize reduction of estate tax for those with taxable estates, all while keeping important asset protection benefits.

Ask us about upgrading your Trust and LLC with *Optimal Basis Increase Clauses.*
WILL YOUR OLD TRUST NOW COST YOU $$$ INCOME TAX ???

Problem:
Over 90% of “A/B” trusts have not been amended and adapted to the tremendous income & estate tax changes since 2013.

Why is this an important issue -- even for married taxpayers with under $10.68 million who are no longer concerned about estate taxes?

So What?
Old-style trusts can cost your surviving spouse 58% higher income tax burdens, and even higher burdens to your descendants through higher ongoing tax rates AND loss of basis increase.

The Solution:
Trusts can be adapted to exploit the new tax law changes to achieve better basis increase, take advantage of income tax loopholes and shift income to beneficiaries in lower tax brackets.

Take Action!
- Ask us about upgrading your trust to an Optimal Basis Increase Trust

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Comparison of Strategies to Achieve Step Up in Basis at First Death for Married (or Unmarried) Couples

Companion Chart to Part V of The Optimal Basis Increase Trust white paper by Ed Morrow, Dec. 2015 version

"CP"="community property". "JEST"="Joint Exemption Step Up Trust"
"GPOA"="general power of appointment"

<table>
<thead>
<tr>
<th>Factors to Consider</th>
<th>Transfer Gain Property to ill spouse &gt; year prior</th>
<th>Alaska/Tenn. CP Trust (Blattmachr, Zaritsky)</th>
<th>Lifetime GPOA Trust (Blase) (Gassman)</th>
<th>Testamentary GPOA (JEST) Trust (Gassman)</th>
<th>Inter-Vivos Estate Trust (Handler)</th>
<th>Upstream Optimal Basis Increase Trust (Morrow)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administrative Issues</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Need independent/corporate trustee in TN/Alaska</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>2 Settlor and/or settlor's spouse can be only trustees</td>
<td>n/a</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>3 Is irrevocable (for CP transfer, spouses can revoke half)</td>
<td>yes</td>
<td>yes (1/2)*</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>4 One year &quot;curing period&quot; required to achieve increase</td>
<td>yes</td>
<td>no*</td>
<td>no*</td>
<td>no*</td>
<td>yes</td>
<td>depends on design</td>
</tr>
</tbody>
</table>

Keeping Fidelity to the Estate Plan of Transferor

| 5 Spouse can take some of transferred assets while living  | yes | yes (1/2) | yes | no | no | no |
| 6 Disinheritance risk if first to die has "2nd thoughts" | yes | yes (1/2) | yes | no* | yes | no* |
| 7 Potential substantial loss if spouses divorce after transfer (for CP Trust, to extent transferred property unequal) | yes | yes | No "floating spouse" clauses | "floating" spouse OK |

Outside Creditor Protection Issues During Life

| 8 Increased creditor exposure if lifetime creditors arise (including destruction of tenancy by the entireties) | yes | yes | yes | ? | no | yes | no |
| 9 Increased creditor protection if lifetime creditors arise | no | no | no | no | somewhat - estate vulnerable | yes |

Outside Creditor Protection Issues at First Death

| 10 Increased creditor exposure of first to die's estate (if the estate is insolvent, e.g. wrongful death accident) | yes | yes (1/2) | yes | no | yes | no |
| 11 Wrongful death lawsuit or major debt against 1st to die's estate could wipe out transferred assets | yes | ? | no | no | yes | no |

* 1014(e) application more uncertain for GPOA
* transmuting to CP may or may not be gift
### Factors to Consider (page 2)

<table>
<thead>
<tr>
<th>Potential Tax/Legal Issues to Thwart Tax Result</th>
<th>Transfer to ill spouse &gt; year prior</th>
<th>Alaska/Tenn. CP Trust</th>
<th>Lifetime GPOA (aka JEST) Trust</th>
<th>Testamentary GPOA (JEST) Trust</th>
<th>Inter-vivos Estate Trust</th>
<th>Upstream Optimal Basis Increase Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>12 Existing PLRs argue to deny step up under §1014(e) * however, it's unclear to what extent and how if in trust)</td>
<td>no</td>
<td>no</td>
<td>yes*</td>
<td>yes*</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>13 U.S. Supreme Court (Harmon) case nearly on point against</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>14 Fractional interest discounting reduces potential step up (Bright, Propstra, Lee cases - 50% is often valued &lt; 1/2 whole)</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>15 Huber -type risk of state public policy arguing against</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>16 Reciprocal gift issue if both spouses create cross-trusts</td>
<td>n/a</td>
<td>n/a</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>17 Step transaction issues due to simultaneous transfers? *immediate &quot;death bed&quot; transfer may still have low risk</td>
<td>no*</td>
<td>no*</td>
<td>possible</td>
<td>possible</td>
<td>no*</td>
<td>no*</td>
</tr>
<tr>
<td>18 Requires using annual, lifetime or other non-marital gift * see discussion of 2523 issues in material</td>
<td>no</td>
<td>no</td>
<td>probably not*</td>
<td>probably not*</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>19 Potential double use of gift tax exclusion if §2523 n/a</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>20 Risk there is no GPOA while donor can still revoke (see arguments in 2007 ABA RPTE letter to IRS re DING trusts)</td>
<td>n/a</td>
<td>n/a</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
</tbody>
</table>

### Potential Market Issues to Thwart Tax Result

<table>
<thead>
<tr>
<th>If asset value/market declines, &quot;double&quot; step down occurs - can be drafted around</th>
<th>yes</th>
<th>yes</th>
<th>yes</th>
<th>yes</th>
<th>yes</th>
<th>no</th>
</tr>
</thead>
<tbody>
<tr>
<td>21</td>
<td>no</td>
<td>unlikely</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
</tr>
</tbody>
</table>

### Other Miscellaneous Issues

<table>
<thead>
<tr>
<th>Must be married (not registered partner, living together)</th>
<th>yes*</th>
<th>yes</th>
<th>yes*</th>
<th>yes*</th>
<th>yes</th>
<th>no</th>
</tr>
</thead>
<tbody>
<tr>
<td>* indicates non-married can use, but causes add'l taxable gift</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Can get step up in basis upon older parent/relatives' death (without using lifetime gift exclusion of donor upon death)</th>
<th>no</th>
<th>no</th>
<th>no</th>
<th>no</th>
<th>no</th>
<th>yes</th>
</tr>
</thead>
</table>

## Comparison of Various Basic Trust Design Options for Married Couples

Companion chart to article, "The Optimal Basis Increase and Income Tax Efficiency Trust" - please consult for explanation of variations (For simplicity, this chart does not compare intervivos SLATs, QTIPs, or other lifetime gifting options, though SLATs may also be adapted) (Some "traditional" bypass or marital trusts may have more features than indicated, this chart compares the "ordinary" common trust for spouse) (Some benefits may be limited/constrained by available applicable exclusion amounts. Assumes beneficiaries are not in top income tax bracket)

<table>
<thead>
<tr>
<th>Key Features</th>
<th>Outright Will or Trust (w/portability)</th>
<th>Traditional Bypass</th>
<th>Traditional QTIP</th>
<th>Traditional GPOA marital</th>
<th>Optimal Basis and Income Tax Efficiency Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Basis Treatment at Death of Surviving Spouse</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 &quot;Step up&quot; in basis at 2nd death (QTIP potentially denied step up per Rev. Proc. 2001-38?)</td>
<td>yes</td>
<td>no</td>
<td>probably</td>
<td>yes</td>
<td>yes* (up to AEA)</td>
</tr>
<tr>
<td>2 No &quot;Step down&quot; in basis on 2nd death</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>3 Avoid potential lesser basis step up when fractional interests (LLC, TIC, etc) fund trust, at 2nd death</td>
<td>n/a</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>yes* (up to AEA)</td>
</tr>
<tr>
<td><strong>Basis Treatment at Death of Beneficiary (Child)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 &quot;Step up&quot; in basis on child's death (if dynastic style, protective trust, to extent still GST exempt)</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>5 No &quot;Step down&quot; in basis on child's death (if dynastic style, protective trust, to extent GST exempt)</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td><strong>Ongoing Income Tax Treatment and Flexibility</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Capital Gains Able to Escape Tax Rate Trap of 43.4% or 23.8% over $12,400 if bene is in lower bracket</td>
<td>n/a</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>7 Ability to spray income to lower tax bracket beneficiaries or possibly even charity</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>8 Ability to spray capital gains as well per 1.643(a)-3</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>9 Ability for &quot;above the line&quot; charitable deduction (must be from gross income, not UBTI, etc, per § 642c, 681</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>10 Ability for spouse to make lifetime LPOA tax-free &quot;gifts&quot;</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>11 Ability for better tax treatment for special assets (personal residence, small business stock, etc)</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes* (if §678(a) used)</td>
</tr>
</tbody>
</table>
### Asset Protection Considerations

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>Inherited Principal protected from creditors (assumes not 401(k), IRA, homestead, etc)</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>13</td>
<td>Income from inherited assets protected from creditors</td>
<td>no</td>
<td>yes*</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>14</td>
<td>Protection from divorce, remarriage, squandering spousal elective share, ERISA/REA, etc</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>15</td>
<td>Better incapacity/management capability</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>16</td>
<td>Potential Medicaid/govt benefits advantage</td>
<td>no</td>
<td>yes</td>
<td>some</td>
<td>no</td>
</tr>
</tbody>
</table>

### Federal Estate/Gift/GST Tax Features

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>17</td>
<td>Inherited assets escape estate tax system at 2nd death</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>18</td>
<td>May increase 2nd death estate over $5.45m, causing a required Form 706 and Forms 8971 w/ $0 basis issues</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>19</td>
<td>Allows dynastic GST use at first death (reverse QTIP)</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>20</td>
<td>No need for timely filed 706/portability to exploit 1st decedent spouse’s $5.45m estate/GST exclusion</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>21</td>
<td>Can save millions in add'l estate tax in event of simultaneous death if one spouse’s estate &gt; $5.45m</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>22</td>
<td>Surviving spouse can remarry w/o jeopardizing first spouse’s use of exclusion (losing DSUE)</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>23</td>
<td>Enables disclaimer funding while still keeping POA</td>
<td>n/a</td>
<td>no</td>
<td>yes</td>
<td>yes*</td>
</tr>
<tr>
<td>24</td>
<td>Enables disclaimer within 9 months of 2nd Death</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
</tbody>
</table>

### State Estate & Income Tax Features

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>25</td>
<td>Inherited assets escape state estate tax at 2nd death</td>
<td>no</td>
<td>yes*</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>26</td>
<td>Ability to spray income to bene in low/no tax state</td>
<td>no</td>
<td>if added</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>27</td>
<td>Ability to shelter trust income from state income tax for trust income (incl CG) not K-1’d to beneficiary See separate article on avoiding Ohio Trust Income Tax acct. income is taxed to bene</td>
<td>no</td>
<td>depends state</td>
<td>no</td>
<td>no</td>
</tr>
</tbody>
</table>
## Comparison of Strategies to Achieve Step Up at 2nd Spouse's Death for Existing Bypass Trusts

Companion Chart to Part VII of The Optimal Basis Increase Trust ("OBIT") white paper by Ed Morrow, Jan. 2015 version

"LPOA" - "limited power of appointment"; "UPOAA"=uniform power of appointment act, a proposed creditor-friendly uniform act; "DTT" = "Delaware Tax Trap" "GPOA"="general power of appointment"

### Technique to Get Full Step Up at 2nd Death

<table>
<thead>
<tr>
<th>Factors to Consider</th>
<th>Terminate Trust, Distribute Property outright to spouse</th>
<th>Use Existing LPOA to Trigger DTT</th>
<th>Add &quot;OBIT&quot; LPOA and Trigger DTT by Formula</th>
<th>Add ordinary testamentary GPOA to Trust</th>
<th>Add Formula GPOA &amp; other shifting (OBIT paper)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administrative Issues</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Need to keep separate trust books/records</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>2 Ongoing legal, accounting and/or trustee fees, &quot;hassle&quot;</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>3 Cannot be easily &quot;undone&quot; (toothpaste out of the tube)</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>4 Requires coordination with will/trust to get &quot;step up&quot;</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>Keeping Fidelity to the Estate Plan of Settlor</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Widow/widower can completely redirect/spend all assets</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>6 Disinheritance risk if widow/widower has &quot;2nd thoughts&quot;</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>7 Susceptible to undo influence</td>
<td>yes</td>
<td>depends</td>
<td>much less</td>
<td>depends</td>
<td>much less</td>
</tr>
<tr>
<td>Creditor Protection Issues During Spouse's Life</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8 Increased creditor exposure if lifetime creditors arise (no exclusion from bankruptcy estate under §541c2)</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>9 Exposure to commingling, division in divorce if remarried</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>10 Consideration as &quot;resource&quot; for Medicaid qualification</td>
<td>yes</td>
<td>no*</td>
<td>no*</td>
<td>no*</td>
<td>no*</td>
</tr>
<tr>
<td>*depends on trust, discretionary WDT or income/HEMS, etc</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Creditor Protection Issues at Second Death</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11 Increased creditor exposure of second to die's estate (if the estate is insolvent, e.g. wrongful death accident)</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>maybe*</td>
<td>no</td>
</tr>
<tr>
<td>(depends state law)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12 Exposure to spousal elective share if spouse remarries</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
</tbody>
</table>
Comparison of Strategies for Step Up In Basis at 2nd Spouse’s Death for Existing Bypass Trusts - Page 2

Factors to Consider (page 2)

<table>
<thead>
<tr>
<th>Potential Tax/Legal Issues to Thwart Tax Result</th>
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<th>Add &quot;OBIT&quot; LPOA and/or Trigger DTT by Formula</th>
<th>Add ordinary testamentary GPOA to Trust</th>
<th>Add Formula GPOA &amp; other shifting &quot;OBIT&quot; trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>13 Congress could change §1014 to eliminate step up</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>14 Taxed if Congress passes &quot;mark to market&quot; income tax at death in lieu of or in addition to estate tax (Greenbook)</td>
<td>yes</td>
<td>depends</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>14 There is no direct on point case or ruling on technique</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>15 Net operating losses or capital loss carryforwards may go wasted if not used on spouse’s final tax return</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>16 Spouse could &quot;win lottery&quot; and transaction costs 40% tax (to the extent spouse attains federally taxable estate)</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>17 Spouse could move to a state with separate estate tax (or, a state could resurrect its E.T.) Typically 12-20% tax</td>
<td>yes</td>
<td>no</td>
<td>unlikely</td>
<td>unlikely</td>
<td>unlikely</td>
</tr>
<tr>
<td>18 Potential taxable gift by remaindermen</td>
<td>yes</td>
<td>no</td>
<td>unlikely</td>
<td>unlikely</td>
<td>unlikely</td>
</tr>
<tr>
<td>20 Gift by remainderman may squelch step up if death &lt; 1 yr</td>
<td>yes</td>
<td>no</td>
<td>unlikely</td>
<td>unlikely</td>
<td>unlikely</td>
</tr>
</tbody>
</table>

Potential Market Issues to Thwart Tax Result

<table>
<thead>
<tr>
<th>Potential Market Issues to Thwart Tax Result</th>
<th>Terminate Trust, Distribute Property outright to spouse</th>
<th>Use Existing LPOA to Trigger DTT</th>
<th>Add &quot;OBIT&quot; LPOA and/or Trigger DTT by Formula</th>
<th>Add ordinary testamentary GPOA to Trust</th>
<th>Add Formula GPOA &amp; other shifting &quot;OBIT&quot; trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>21 If asset value/market declines, step down occurs</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
</tbody>
</table>

Other Income Tax Benefits IF Trust Amended

<table>
<thead>
<tr>
<th>Other Income Tax Benefits IF Trust Amended</th>
<th>Terminate Trust, Distribute Property outright to spouse</th>
<th>Use Existing LPOA to Trigger DTT</th>
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<th>Add Formula GPOA &amp; other shifting &quot;OBIT&quot; trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>22 Ability to shift income to beneficiary’s low/0% tax brackets</td>
<td>no</td>
<td>yes*</td>
<td>yes*</td>
<td>yes*</td>
<td>yes*</td>
</tr>
<tr>
<td>23 Ability to deduct charitable gifts from 3.8% NIIT surtax</td>
<td>no</td>
<td>yes*</td>
<td>yes*</td>
<td>yes*</td>
<td>yes*</td>
</tr>
<tr>
<td>24 Ability to efficiently defer income via distribution to CRUT</td>
<td>no</td>
<td>yes*</td>
<td>yes*</td>
<td>yes*</td>
<td>yes*</td>
</tr>
<tr>
<td>25 Ability to achieve grantor trust status, allowing all income to be reported on Form 1040, swap gain/loss assets, etc (this would be in lieu of above 3 non-grantor trust advantages)</td>
<td>no</td>
<td>yes*</td>
<td>yes*</td>
<td>yes*</td>
<td>yes*</td>
</tr>
</tbody>
</table>

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## Comparison of DAPT v. Lifetime Limited Power of Appointment (LLPOA) Trust Design Options

Companion chart to OSBA Wealth Transfer Planning CLE June 13, 2013. Please consult that text for more detailed explanation of variations. 

Abbreviations: DAPT = Domestic Asset Protection Trust. GPOA = general power of appointment. LPOA = limited power of appointment. LLPOA = lifetime limited power of appointment. For this chart, assumes settlor/donor is not the powerholder, but a mere potential appointee. 
OLT = Ohio Legacy Trust, Ohio's DAPT statute at 5816.01 et seq. PH = powerholder. All trusts in chart assumed irrevocable. 
SOL = Statute of Limitations, FT=fraudulent transfer, UFTA = Uniform Fraudulent Transfers Act. 
ING = Incomplete, Non-Grantor Trust. 

<table>
<thead>
<tr>
<th>Key Features</th>
<th>Outright gift to a donee (beneficiary) other than donor</th>
<th>Self Settled DAPT (OH OLT or other) Settlor is bene</th>
<th>Non self-Settled &quot;Power&quot; Trust w/LLPOA that is also OLT Settlor is not bene</th>
<th>Non Self-Settled Power Trust w/LLPOA (beneficiary) OLT or other) Trust w/LLPOA that is also OLT Settlor is not bene</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>How Donor Could Access Funds Post-Transfer</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 There is a Fiduciary Duty owed to Donor as a beneficiary (must typically consider all beneficiaries and evaluate distribution requests based on standards in document)</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>2 Powerholder can give back arbitrarily, w/ No fiduciary duty (need not consider other beneficiaries, can be arbitrary)</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>3 Possible grounds for suit from benes if all funds revert to settlor</td>
<td>n/a</td>
<td>yes</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td><strong>Gift Taxation of Any Donor Access Post-Transfer</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Taxable gift if funds come back to donor (if trust is designed as an incomplete gift)</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>5 Taxable gift if funds come back to donor (if trust is designed as a completed gift)</td>
<td>yes</td>
<td>no</td>
<td>Perhaps partial gift if LLPOA PH has a interest (Regester)</td>
<td>Perhaps partial gift if LLPOA PH has a interest (Regester)</td>
</tr>
<tr>
<td><strong>Ongoing Income Tax Treatment and Flexibility</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Easy to Structure as a Grantor Trust</td>
<td>n/a</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>7 Easy to Structure as a Non-Grantor Trust</td>
<td>n/a</td>
<td>no, but see ING PLRs</td>
<td>yes, if LLPOA PH is adverse (a benef)</td>
<td>yes, if LLPOA PH is adverse (a benef)</td>
</tr>
<tr>
<td>8 Non-Grantor Trust, could spray income post-transfer</td>
<td>n/a</td>
<td>yes, if qualified</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td><strong>Gift Tax Treatment and Flexibility</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9 Easy to Structure as an incomplete gift</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>10 Easy to Structure and ensure a completed gift (for married donor - is it complete if spouse as creditor can access?)</td>
<td>yes</td>
<td>no, but possible, see PLRs</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td></td>
<td>Completed Gifts Remain Outside of Estate, no §2036 issue (though there is always &quot;prearrangement&quot;/&quot;understanding&quot; risk)</td>
<td>yes</td>
<td>unclear, and PLRs will not address</td>
<td>yes</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>12</td>
<td>Could double as inter-vivos QTIP to exploit &quot;poorer spouse&quot; funding and use $5.43 million GST via reverse QTIP</td>
<td>n/a</td>
<td>no</td>
<td>yes, if LLPOA is inactive &lt; SS's death</td>
</tr>
<tr>
<td>13</td>
<td>Can help protect special self-settled trusts (CRT, QPRT, GRAT) by protecting grantor's retained income/unitrust</td>
<td>n/a</td>
<td>yes</td>
<td>n/a</td>
</tr>
<tr>
<td>14</td>
<td>In discovery/bankruptcy filing - must disclose being beneficiary</td>
<td>n/a</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>15</td>
<td>Clear that 11 USC §548(e) 10 year FT SOL could apply (Mortensen, Huber cases)</td>
<td>n/a</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>16</td>
<td>Court potentially &quot;freezing out&quot; settlor/beneficiary (Grant case)</td>
<td>n/a</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>17</td>
<td>Exception creditors of settlor can reach assets even if there is no fraudulent transfer, by spendthrift exception</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>18</td>
<td>Shorter SOL, tougher fraudulent transfer standards apply to help donor and deter later creditors (nonbankruptcy)</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>19</td>
<td>Requires Affidavit of Solvency for all Transfers</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>20</td>
<td>Potential Medicaid/govt benefits advantage &gt; 5 yrs</td>
<td>yes</td>
<td>no</td>
<td>unknown</td>
</tr>
<tr>
<td>21</td>
<td>Greater chance of other state law applying in conflict</td>
<td>n/a</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>22</td>
<td>Strong chance of continued creditor protection even if out of state (non-DAPT) law held to apply</td>
<td>n/a</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>23</td>
<td>Chance of Federal Tax Lien attaching to Settlor as beneficiary</td>
<td>n/a</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>24</td>
<td>Property is subject to beneficiary's creditors (absent 5% power, mandatory interest or termination date, etc)</td>
<td>yes</td>
<td>no</td>
<td>no</td>
</tr>
</tbody>
</table>

**State (Ohio) Income Tax Features**

|   | May escape Ohio income taxation if no CURRENT bene in state (assumes settlor is Ohio resident, trust is non-grantor) (see separate Probate Law Journal of Ohio article) | no | no | yes | yes |

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