Estate Planning With Marital Trusts
Post-ATRA: Optimizing Basis Step-Up and Leveraging AB and QTIP Trusts

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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 January 2015)

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1 Portions of this outline were presented at other CLEs 2011-2014 and were published in Trusts and Estates, Leimberg LISI Estate Planning Newsletter or CCH Estate Planning Review. © 2011-2014 Edwin P. Morrow III – Contact: edwin_p_morrow@keybank.com, or edwin.morrow3@gmail.com. See this website for further updates: http://ssrn.com/abstract=2436964 or http://dx.doi.org/10.2139/ssrn.2436964
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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 (sophisticated practitioners should skip this section). 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 diverts to discuss various “double step up at first death” techniques. Part VI posits new asset protection opportunities. Part VII extols 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 attached chart 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”. 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).

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 Trust as well as a “fraud upon the public”. 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, page 95

\(^10\) 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 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 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 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 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 before the one year required by statute. This can be waived 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 remarries 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;  

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

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15 This is not to say that prenuptial agreements should not address DSUE and portability – they should. See Karibjanian 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.\(^\text{19}\)

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\(^{16}\) 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.\(^2\)

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 excess times 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 utilize 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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\(^2\) 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 overridden the Uniform Simultaneous Death Act and the IRS would respect the marital trust and hence add enough assets to Jane’s estate to use both exemptions. 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.
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 QTIP21 to save the use of the exclusion via bypass trust even if the Form 706 filing to claim portability is botched.22 The Clayton QTIP/bypass trust combination may also save additional basis if the surviving spouse dies within 15 months.23

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21 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.”

22 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 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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23 As discussed in the next Part II, page 15, QTIP's 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.


25 Treas. Reg. §25.2518-2(c)(4)(iii), even though IRC §2040(b) would deem 50% to be in each spouse’s estate
couples percentage points.\textsuperscript{26} 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.\textsuperscript{27} 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 trust pay to the surviving spouse’s estate. A GPOA marital is not much 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.\textsuperscript{28} 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.\textsuperscript{29} Because of this and other advantages, QTIPs are by far the most preferred.\textsuperscript{30} 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).

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

\textsuperscript{26} 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.
\textsuperscript{27} IRC §1014(b)(6),(9), (10).
\textsuperscript{28} IRC §2056(b)(5), Treas. Reg. §20.2056(b)(5)(g)
\textsuperscript{29} At IRC §2056(b)(7) and IRC §2056(b)(5) respectively
\textsuperscript{30} 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.
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.\footnote{Under IRC § §1014(b)(9), not IRC §1014(b)(10)}

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.\footnote{See, The General Power of Appointment Trust is Back, Bruce Steiner, LISI Estate Planning Newsletter #2060 (February 6, 2013).}  

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 to permit taxpayers and the IRS to disregard a QTIP election, even though the election is irrevocable, under certain circumstances. It was clearly designed to help taxpayers who unnecessarily over-qtipped what should have remained a bypass trust. 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.”\footnote{IRS Rev. Proc. 2001-38, see also PLRs 2009-18014, 2007-29028, 2010-36013, voiding valid QTIP elections}

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. This unilateral revenue procedure should not entitle the IRS to retroactively disregard a validly made statutorily granted QTIP election on their own accord. Rev. Procs cannot overrule statute and treasury regulation!

However, until the IRS issues further guidance, some practitioners may prefer to avoid the issue altogether and use a marital GPOA (or use intervivos QTIPs, to which the Rev. Proc. does not apply if your state has fixed other intervivos QTIP problems).\footnote{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/transferror 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 (Code §112.035(g)), South Carolina}
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 the Rev. Proc. not only to clarify this point, but to prevent other obvious abuses of the procedure.\footnote{35 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 \S 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.}

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, etc. We haven’t had a bad one in the last five years, but it will come again eventually. Say when the surviving spouse dies the QTIP has assets worth $3 million, with basis $4 million. The QTIP election wasn’t needed, isn’t desired with 20/20 hindsight - it was made purely on assumption that basis would increase 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, restoring $1 million basis? Why not? 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.

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 (an LLC would probably have a greater discount than a 50% tenancy in common interest).

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.36

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

There may be a solution for the fractional interest discount issue, although many practitioners will find it odd and counterintuitive – use a formula general power of appointment (discussed in Part III) designed to pull such assets into the estate under IRC § 2041 rather than IRC §2044 to accomplish consolidation for valuation purposes. Such a power would be designed to not 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. 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 $2 million estate, $3 million in QTIP, part of which is comprised of $2 million property, in LLC owned by her and QTIP as 50/50%, valued at $700,000 for each interest. A GPOA would aggregate the valuation so to increase the gross estate to $5.6 million, causing an estate tax (ignoring deductions, assuming no DSUE, $5.34 million AEA), but if the estate were a bit smaller or the AEA larger, such a provision could add $600,000 of basis. See various examples in appendix and discussion of capping GPOAs in Part III.

Query whether inclusion via IRC §2041(a)(3) (using a limited testamentary power of appointment and triggering the Delaware tax trap) will lead to the same aggregation? While it is triggering the same statute causing estate inclusion (§2041), the same public policy

argument discussed in the cases and IRS memos justifying the valuation aggregation for GPOAs is not quite there. In short, it’s a tenable argument but too uncertain to count on.

f. **Summarizing Benefits and Drawbacks Endemic to all Marital Trusts**

Thus, marital trust planning can combine the income tax basis benefit of the outright/portability option with the estate preservation and 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 twelve 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, 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 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. They cannot use broad *lifetime* limited powers of appointment – which can be important for gifting and income tax planning techniques discussed in Part VIII.37 They cannot be used by non-traditional couples who are not officially recognized as “married.”38 QTIPs have more onerous tax apportionment.39 DSUE gained through overuse of marital trusts can be lost. Furthermore, they simply won’t be as efficient in saving state estate taxes or federal estate taxes for estates close to the applicable exclusion amount, especially if the surviving spouse does live long and assets appreciate significantly, since the DSUEA 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:

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37 IRC §2056(b)(7)(B)(ii)
38 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.
39 IRC §2207A
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;

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;

6) giving the surviving spouse a limited power to appoint that alternatively cascades to
general power to the extent not exercised.

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

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40 This is known as a collateral power, See Restatement Property, Third, Donative Transfers, §17.3, comment f
41 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
42 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.
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 disinheritance 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.\(^{43}\) 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.\(^{44}\) 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.\(^{45}\) However, it merely begs the question – if it’s worth doing later, why isn’t it worth doing now before it’s too late?

Leaving the ability for a trust protector to add GPOA basis savings clauses later 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. Why not add the safety net now and allow it to be amended?

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

\(^{43}\) 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.

\(^{44}\) 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).

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). The reason is that this may be deemed to be a general power of appointment over the entire trust in itself. Consider this: 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. Is this so different from a non-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. Since the trustee or powerholder in these scenarios is non-adverse, aren’t these situations similar to the spouse and non-adverse trust protector if considered together having a GPOA as some would argue? 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. Would it matter if the trust protector or other advisor is considered a fiduciary and held to fiduciary duties in his or her ability to add a GPOA? Some attorneys and state law allow trust protectors/advisors to be considered non-fiduciaries. Those may be riskier.

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 limiting the potential category and amount of appointive assets in the same manner as discussed in the following Part III.

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46 Identifying and Respecting the Core Elements of a Modern Trust, comments by Ronald Aucutt, 48th Annual Heckerling Institute on Estate Planning ¶1305.1[B]
47 IRC §2041(b)(1)(C)(ii)
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.*\(^{48}\) 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.\(^ {49}\) 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.\(^{50}\) 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 *Optimal Basis Increase Trust* (OBIT).

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48 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.

49 Treas. Reg. §20.2056(b)-7(b)(3)

50 Treas. Reg. §20.2056(b)-7(b)(2)
"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."

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>Description</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional deductible IRA</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>
<td>$1,000,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>LT Bond portfolio (inflation depressed value)</td>
<td>$400,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Various stocks that have decreased in value</td>
<td>$150,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total “loss” property</td>
<td>$2,050,000, FMV $1,200,000</td>
<td></td>
</tr>
<tr>
<td>Rental Real Estate</td>
<td>$200,000</td>
<td>$600,000</td>
</tr>
</tbody>
</table>

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51 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 state 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.

52 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 basis $400,000, FMV $900,000
ST Bond Portfolio, Money market, Cash basis $400,000, FMV $400,000
Gold basis $100,000 FMV $200,000
Total “gain” property basis $1,100,000, FMV $2,100,000
Total at Jane’s death 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.\(^{53}\) 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 \textit{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 \textit{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.

\(^{53}\) 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)

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

<table>
<thead>
<tr>
<th>New Basis at Surviving Spouse’s Death if using:</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>
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<td>$1,000,000</td>
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<td>$400,000</td>
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<td>$150,000</td>
<td>$100,000</td>
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<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.54 All of our traditional planning has A/B/C, GST formulas that the IRS has blessed and this should be no different.55 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.

d. Determining the Appointive Assets When the GPOA is Capped

54 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).

55 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 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.” 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(e)(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.
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.56 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.57

56 IRC §1022
57 See IRS Chief Counsel Memorandum (CCM) 200644020 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 the date of the decedent's death (the applicable valuation date), in satisfaction of the decedent's bequest in trust for the benefit of his wife of cash or securities to be selected by the executor in an amount sufficient to utilize the marital deduction to the maximum extent authorized by law (after taking into consideration any other property qualifying for the marital deduction), capital gain in the amount of $25,000 would be realized by the estate and the
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. 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 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.\textsuperscript{60}

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.\textsuperscript{61} 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 \textit{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?\textsuperscript{62} 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 $200,000, or $33,333).\textsuperscript{63} This means a basis increase from $200,000 to $533,333. This

\textsuperscript{60} See comment g in \textit{Restatement, Third, Property, Wills and Other Donative Transfers} §17.1

\textsuperscript{61} Rev. Proc. 64-19, which has to do with post-mortem gains/losses when distributing in kind based on DOD value

\textsuperscript{62} 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.

\textsuperscript{63} 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.
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 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 as well.

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,

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64 IRC §6018(a)
65 Treas. Reg. § 1.1014-3
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. There is a longstanding duty of impartiality imposed on trustees. 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.”

Still, this may simply 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. 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 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.

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66 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.
67 Restatement, 3d, Trusts, §79(2), §183, Uniform Trust Code §803, Bogert’s Trusts and Trustees, Ch. 26 § 541
68 Treas. Reg. §25.2514-1(b)(1)
69 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).
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.\(^{70}\) 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.\(^{71}\)

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 Ohio, Indiana Minnesota and other states). Some states have larger exemptions of $2 million, $3.5 million or more that make it more compelling.

\(^{70}\) 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.

\(^{71}\) 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.picpa.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).
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.  

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.

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72 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.\(^73\) 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”.\(^74\) 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.”\(^75\) My beneficiary also may appoint to creditors of his or her estate.”\(^76\)

\(^73\) 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.

\(^74\) 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.

\(^75\) 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

\(^76\) 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.
Furthermore, a power is still a GPOA if it may only be exercised with the consent of a non-adverse party.\textsuperscript{77} 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{78} 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{79}

Surprisingly, even a trustee with fiduciary duties to beneficiaries who would clearly be adverse is not considered adverse itself.\textsuperscript{80} 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.

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

\textsuperscript{77} IRC §2041(b)(1)(C)(ii), Treas. Reg. §20.2041-3(c)(2) As for spousal POAs, see also Rev. Rul. 82-156.
\textsuperscript{78} Paraphrasing \textit{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{79} 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{80} An independent bank co-trustee, for example, is not sufficiently adverse. \textit{Estate of Vissering v. Commissioner}, 96 T.C. 749 (1971), reversed on other grounds, \textit{Estate of Jones v. Commissioner}, 56 T.C. 35 (1971), \textit{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?)
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.81 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).82 Although the OBIT techniques herein to increase basis would not apply to IRAs or qualified plans,83 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 legally enforceable debt and to reasonably equivalent value for contractual debt. Otherwise, a powerholder could in theory borrow $1 from anyone and/or

81 Treas. Reg. §20.2041-3(b)
82 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 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.
83 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{84}

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{85} 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{84} 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{85} 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 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.  

In bankruptcy the assets are clearly **not** subject to creditors. 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:

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§ 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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86 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.”

For debtor-friendly, see South Dakota CL §55-1-26: “Judicial foreclosure of beneficial interests, powers of appointment, and reserved powers prohibited—Creditors may not reach powers of appointment or remainder interests. Regardless of whether or not a trust contains a spendthrift provision: (1) No beneficial interest, power of appointment, or reserved power in a trust may be judicially foreclosed; (2) No creditor may reach a power of appointment or a remainder interest at the trust level. The creditor shall wait until the funds are distributed before the creditor may reach the funds; and (3) No power of appointment is a property interest.”

Rhode Island: § 34-22-13. “Powers as subjecting property to creditors: Except to the extent that a donee shall appoint to his or her estate or to his or her creditors, §§ 34-22-11 and 34-22-12 shall not be construed to subject to the claims of creditors of the donee the property which the donee is authorized to appoint.” Similar, Alaska Stat. § 34.40.115, New York: N.Y. EPT. LAW § 10-7.4

87 For a recent bankruptcy case discussing why non-presently exercisable (testamentary) and non-general powers do not cause inclusion of appointive assets in a bankruptcy estate, see *Casey v. Schneider (In re Behan)*, 506 B.R. 8 (Bankr. D. Mass. 2014), as well as 11 U.S.C. §541(c)(2)

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

89 *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]  

Surprisingly, the Uniform Probate Code also seems protective of testamentary GPOAs as against non-spousal creditors. 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.  

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. 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

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90 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.  
91 See Uniform Probate Code §6-102, comment 3: “The definition of ‘nonprobate transfer’ in subsection (a) includes 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.”  
92 See discussion of PLR 9110054 in section III.m. below and sample clauses in appendix.  
93 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.94

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) What if the power holder changes state of residency? For instance, from Rhode Island to California. Which state 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. Can this be changed? Can we import or declare a particular state law to apply and would it hold up as against creditors?

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 ¶13.2 discussed above.

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.

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 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.95 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

94 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”)

95 See various clauses in appendix
to children/trust be deemed an exercise of a GPOA under state law where a concurrent one exists? Uncertain, but it can’t hurt to separate.

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. My own suggestion would be to ignore this in drafting the formula GPOA as currently a “non-issue”, but note the settlor’s concern about future legislation expanding the spousal elective share to any statement of material purpose or trust protector or amendment clause that outlines the scope of potential future amendments.

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 may not be 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 well-drafted contract would probably exclude such assets anyway, but it merits examination nonetheless.

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96 E.g., comments by Paul Lee, Jeff Pennell, as well as Heckerling comments that they are “too complicated”

97 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.
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”).

“(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.

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98 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.

99 For your specific state, see Howard Zaritsky’s ACTEC 50 State and D.C. Survey of Rule Against Perpetuities Law, specifically p 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, Johnathan Blattmachr and Jeffrey Pennell, 68 Journal of Taxation 242 (1988), 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 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 (sometimes 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.100

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).”101

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.102

100 See discussion in ACTEC survey and articles cited in the above footnote. All of those, plus other sources I consulted, 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 appears to be the conclusion of both accomplished authors and Treasury’s own examples on this page. Query whether a power of appointment may 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. Without researching, my guess is that states would have closed what would have been quite a dangerous tax trap years ago.

101 Treas. Reg. §20.2041-3(e)(2). There is a near identical gift tax reg at Treas. Reg. §25.2514-3(d)

102 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 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 other permitted state. 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.\textsuperscript{103}

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.\textsuperscript{104} 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.

\textsuperscript{103} IRC §2514(c) – the so called “5 and 5” lapse protection.

\textsuperscript{104} 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.\textsuperscript{105}

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 (this would be rare, however, since LPOAs usually \textit{exclude} subsequent spouses as potential appointees, but it is possible – imagine the LPOA in the bypass or other inherited trust is broad enough to permit appointment to a spouse, in which 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 – this is advantage of LPOA/DTT over formula GPOAs – see discussion below). Non-adverse party consent may also make the GPOA not “presently exercisable”, required for 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.\textsuperscript{106}

\textbf{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.

\textsuperscript{105} Treas. Reg. §20.2041-3(e)(2), there is a nearly identical gift tax regulation at §25.2514-3(d)

\textsuperscript{106} See \url{http://www.actec.org/public/Document/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 (or, treacherous, if dealing with an inadvertent appointment and large estates) statutes, in that appointing to a trust that grants a \textit{testamentary} GPOA can also trigger 2041(a)(3), which would at least improve upon the asset protection/control issues.
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 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.\(^\text{107}\) 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.\(^\text{108}\)

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 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.”\(^\text{109}\)

\(^{107}\) 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”

\(^{108}\) “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

\(^{109}\) PLR 9527024
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 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. 110 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 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

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110 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.
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 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

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111 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
(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.\(^\text{112}\) 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, 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!\(^\text{113}\) OBIT formulas are similar to disclaimer and QTIP formulas in the regulations.

\(^{112}\) This is essentially paraphrasing the 7th Circuit’s Kurz opinion, at page 1029

\(^{113}\) 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.”
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. 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. 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. 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, 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

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114 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
115 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
116 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.
“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.117

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117 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.”
**o. 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. Unless the appointment triggers the DTT, or unless income is mandated payable to the powerholder, there is no gift, 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?

- **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 (e.g. CA allows creditor access), and potentially whether the GPOA is *exercised*, creditors of the testamentary GPOA powerholder’s estate may have access (see 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.

- **Easier to go beyond formula wherever/whenever inclusion may be desirable** – Because the LPOA in the document would not be limited by formula, it can easily be used to cause inclusion beyond 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 income taxes saved by beneficiaries 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 already is somewhat - consider low basis collectibles taxed to a beneficiary in a high tax state (31.8% federal +up to 13.3%) with no estate tax (40% federal).
- **Actions of the powerholder/trustee irrelevant.** As discussed herein, there is a weak argument that trustee’s investment policy, powerholder spending or estate devise, pursuant to the *Kurz* case or otherwise, could be invoked to override the cap and cause more assets than desired to be subject to a formula testamentary GPOA. 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 have more post-mortem control over estate taxation/basis** – A recipient/appointee might 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, but it is impossible for recipients to affect whether a GPOA is held at death or not. This could be important to flexibly allow increased inclusion for state estate tax purposes to yield federal, state and/or local income tax benefits by additional step up, or prevent over-inclusion. Disclaimers can be made partial or by formula.  

  For example, Jane Doe has the limited power to appoint to the Jane Doe Delaware Tax Trapping Trust fbo Margaret, which grants Margaret a PEG power (presently exercisable general power of appointment). To the extent Jane appoints to this trust, and Margaret has a PEG power, it triggers IRC §2041(a)(3) – the Delaware Tax Trap. But, what if Margaret makes a qualified disclaimer of the GPOA, which relates back to remove her power ab initio? She can disclaim the GPOA and even remain trustee and beneficiary as long as her discretion is limited to an ascertainable standard.  

  *This appears to allow Margaret, the beneficiary/appointee, to eliminate any estate inclusion due to the DTT, and hence any basis adjustment, by qualified disclaimer.* Non-qualified renunciations are disregarded.

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118 E.g. *Estate of Christiansen v. Comm.*, 586 F.3d 1061(8th Cir. 2009)


(iii) Powers of appointment. A power of appointment with respect to property is treated as a separate interest in such property and such power of appointment with respect to all or an undivided portion of such property may be disclaimed independently from any other interests separately created by the transferor in the property if the requirements of section 2518(b) are met. See example (21) of paragraph (d) of this section. Further, a disclaimer of a power of appointment with respect to property is a qualified disclaimer only if any right to direct the beneficial enjoyment of the property which is retained by the disclaimant is limited by an ascertainable standard. See example (9) of paragraph (d) of this section.

120 Treas. Reg. 20.2041-1(e): “However, regardless of local law, a power of appointment is considered as exercised for purposes of section 2041 ***irrespective of whether *** the appointee renounces any right to take under the appointment.” Presumably, Treasury did not mean “disclaims” instead of “renounces” here.
- You can give your most trusted beneficiaries a de facto veto power, allowing more family control and more post-mortem flexibility. 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 influence she might encounter without me! Remember, however, estate inclusion/GPOA status 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 or unduly influence the “non-adverse party” - and they would have absolutely no fiduciary duty whatsoever to my daughters (and they, no recourse). But §2041(a)(3) does not rely on a definition of a general power of appointment in §2041(b) – it pertains to the exercise of a limited power. If my daughters determine that for asset protection, dynastic, GST or other reasons they’d just as soon not allow the appointment, or would like to limit the appointment to the Delaware Tax Trapping Trust to certain assets, they can if I allow.

In fact, 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). It gives an additional 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 can disclaim PEG powers, some states (and IRS liens), do not follow the relation back doctrine as to creditor protection, so required consent may be superior.121

- An LPOA/DTT can be used by a QTIP as well. This point is a bit non-sequitur, but I felt worth a mention here while discussing DTT nuances. 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 a home and an LLC both worth $1 million, each 50% owned outright, 50% in trust, the beneficiaries will get “discounted” adjustments to basis, shaving off hundreds of thousands of dollars of valuable basis - inclusion under §2041 should lead to aggregation overriding the QTIP’s segregation of valuation.

121 See various cases and statutes cited in footnote 24, notable exceptions – Medicaid look back, 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.

- **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. Plus, it needs a new separate “DTT-trapping” trust to appoint to (even if it’s only one page, or referring to another trust with a sentence added).

- **Better ongoing asset protection for beneficiaries** – although the LPOA/DTT technique might be more prone to access by a powerholder’s estate (discussed above), it is much more likely that one of the children have 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.\(^{122}\) Query how a PEG power over only a remainder would be viewed.

- **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).

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\(^{122}\) This is contrary to a *testamentary* power, as discussed in Part III.h. – see citations in that section.
- **Children or other beneficiaries can spray income** – If a beneficiary receives trust assets with a typical PEG Power, there is a forced grantor trust 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 (discussed in Part VII).

- **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 would be an assignment of income. By contrast, if a beneficiary receives assets without that burden, 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 moves states, will the new state of residency have the same ability to trigger the DTT? Perhaps, but maybe not. It raises another potential issue that formula GPOAs do not.

- **For intervivos SLATs, can revert to Settlor w/o impairing protection** – If the trust 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 be considered the new grantor/settlor, but if the spouse merely executed an LPOA, this would “relate back” and therefore under most state laws the original settlor would 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 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 would 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.\(^{123}\) 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 bar/legislature to consider.\(^{124}\) More will certainly follow. In the Appendix is a proposed variant of Delaware’s law, modified for use in Ohio.\(^{125}\)

\(^{123}\) 5 Del. Code Title 25, § 504, amended by 79 Del. Laws, c. 352 (effective August 1, 2014)

\(^{124}\) 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.

\(^{125}\) 25 Del. Code §504
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 spouses are much more nuanced than that:126

“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 discretion 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.

126 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 DE 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). 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. 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.

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.

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127 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.

128 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”).

129 See, e.g., the Uniform Powers of Appointment Act, §401 and §404, at www.uniformlaws.org, but see Mich. Comp. Laws §556.118(2) for a counterexample.
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).\(^{130}\) 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.\(^{131}\)

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.\(^{132}\)

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.\(^{133}\)

\(^{130}\) 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

\(^{131}\) *U.S. v. Elam*, 112 F.3d 1036 (9th Cir. 1997)

\(^{132}\) Sixteen states have adopted the Uniform Disposition of Community Property Rights at Death Act as of 2014 (at [www.uniformlaws.org](http://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. **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).\(^{134}\) 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.\(^{135}\)

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.\(^ {136}\) The only IRS pronouncement, a mere parenthetical in an IRS publication, takes no position.\(^ {137}\) Wisconsin’s statute that defaults to community property but allows a married couple to opt out received a favorable IRS revenue ruling.\(^ {138}\) There is no such ruling for elective community property trusts, however.

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133 E.g. **all** community property may be susceptible to creditors of only **one** spouse! Tex. Fam. Code §3.202(d)
134 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).
135 Rev. Rul. 66-283
136 Alaska Stat. §34.77.010 et seq. with the community property trust requirements at §34.77.100
137 IRS Publication #555 “Community Property”, page 2
138 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{139} 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{140}

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{141} 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 Washington’s public policy against self-settled trusts trumped a trust’s choice of Alaska law.\textsuperscript{142}

Many couples may not be interested in a solution that requires Alaska 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 are simply a lot of 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{143} Ohio’s statute may well prohibits its residents from using this technique, because such transfers would “alter their legal relations”.

\textsuperscript{139} \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.


\textsuperscript{141} See Restatement, Second, of Conflicts of Laws, §258, comment b, and §270 (regarding trusts). See also Uniform Probate Code §2-703

\textsuperscript{142} \textit{In re Huber}, 2013 Bankr. LEXIS 2038 (May 13, 2013)

\textsuperscript{143} 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.”
c. Attaining Additional Basis at First Death – Integrating Optimal Basis Techniques

The so-called “joint GPOA” (fka 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.\(^{144}\) 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.\(^ {145}\) Copying PLR 2006-04028, H puts his $2 million into his revocable living trust, W puts her $2 million into her revocable living trust.\(^ {146}\) 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 required. In addition to

\(^{144}\) 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.

\(^{145}\) 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.

\(^{146}\) 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.
these two main issues, there are also potential issues with the step transaction doctrine, reciprocal trusts and state law creditor protection issues.

d. **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.\(^{115}\)

   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 $2 million 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 decent argument and several PLRs. After all, as discussed in Parts I and II of this article, treasury regulations accept the fiction of surviving spouses in qualifying for the marital estate tax

\(^{115}\) 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 Hohnadell, respectively. The issues are much more complex than you would think for a simple technique.
deduction in simultaneous death scenarios, and there are cases that suggest the gift at the moment of death is to a surviving spouse.\textsuperscript{148}

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 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.\textsuperscript{149} If a spouse or charity owns portions of the 60\% it may be deductible for gift tax.\textsuperscript{150}

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.”\textsuperscript{151}

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


\textsuperscript{149} Treas. Reg. §25.2511-1(h)(1)

\textsuperscript{150} 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.

\textsuperscript{151} Treas. Reg. §25.2511-1(e)
address ways to integrate the two statutes into planning and use savings clauses to prevent estates from the potential negative interpretations.

e. **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 similar facts did address this issue, and would deny the step up.152 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:

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

Did H “acquire the property by gift”? Arguably, H never received the property – for the same good reasons that argue 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
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152 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.
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 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.153

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

153 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”
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 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.¹⁵⁴

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

¹⁵⁴ PLR 201122007
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 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 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?\textsuperscript{155} 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 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.\textsuperscript{156} Protective elections are also specifically permitted.\textsuperscript{157} 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?

\textsuperscript{155} 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.”

\textsuperscript{156} 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.”

\textsuperscript{157} Treas. Reg. §20.2056(b)-7(c)
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.”

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.

f. 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. 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.

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

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158 See LISI Estate Planning Newsletter #2094, David Handler & the Estate Trust Revival: Maximizing Full Basis Step-Up
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.

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.”
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 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.
g. “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.

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160 IRS Technical Advice Memorandum (TAM) 2009-07025
h. **The Upstream Crummey Optimal Basis Increase Trust**\(^{161}\)

“[O]ne of the major purposes of the federal gift tax statute [is to protect] the estate tax and the income tax”\(^{162}\)

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 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.\(^{163}\) With clear revenue rulings on point, this installment sale is typically ignored for income tax purposes.\(^{164}\)

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\(^{161}\) Portions of this section were published in *The Upstream Crummey Optimal Basis Increase Trust*, May 2014 issue of CCH Estate Planning Review


\(^{163}\) 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.

\(^{164}\) Rev. Rul. 85-13, 1985-1 CB 184, most recently followed by IRS in CCA 2013-43021.
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.\(^{165}\)

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 power can be granted to only the first to die (a reverse tontine),\(^{166}\) 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 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, either one may achieve the same result of a step up in basis. Which method to choose may depend on

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\(^{165}\) 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.

\(^{166}\) 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.
state creditor and asset protection trust law, the financial position of the parent and the
importance of continuing asset protection and/or control to the settlor.

To ensure qualification for the annual exclusion gift under the *Crummey* 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 may be 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 *Crummey* 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 (Crummey 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 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.167 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
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,

167 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
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” as required by §1014? 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. 168 Thankfully, neither would be an issue here, unless John were to die first. 169

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, 170 or to Jane, his wife. 171 Or to a revocable trust or other trust that would qualify as a grantor trust for them due to a withdrawal power over all taxable income and/or principal, as discussed in Part VIII.

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168 Reg. §1.1001-2, ex. 5.
169 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 dying before the other three without warning are extremely slim.
170 This ability should not compromise the asset protection or completed gift status of the initial gift.
171 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
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.\textsuperscript{172} Ordinary exercises of limited powers of appointment clearly have no effect on the grantor for income tax purposes.\textsuperscript{173}

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 intervivos 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”.

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?

\textsuperscript{172} See Reg. §1.671-2(e):

\begin{enumerate}
\item 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.
\item (i) A gratuitous transfer is any transfer other than a transfer for fair market value.
\end{enumerate}

\textsuperscript{173} See Reg. §1.671-2(e)(5):

\begin{enumerate}
\item 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 \textit{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.
\end{enumerate}

\textbf{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.

\textsuperscript{173} Reg. §1.671-2(e)(5), above.
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 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 shift future income to children/grandchildren who are likely subject to lower income tax rates, avoid Pease limitation, get better charitable deductions and/or perhaps most importantly, avoid state income taxes.174

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?175 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 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.176

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

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174 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.
176 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.
receiving it from the decedent’s direct or indirect transfer. John would not be acquiring the property \textit{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 lapse) can devolve the assets to the grantor’s spouse Jane instead (or a grantor trust therefore), or exercise the GPOA and forget trying to lapse, exercise of a GPOA by will comes under Code Sec. 1014(b)(4), not (b)(9).\textsuperscript{177}

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 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{178}

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, \textit{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

\textsuperscript{177} 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{178} Testamentary 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 recent Heckerling conference, third-party created testamentary GPOAs and LPOAs are generally \textit{not} subject to state statutory share laws. See Uniform Probate Code §2-201, §2-205(1)(A), Fla. Stat. 732.2045, \textit{Bongaards v. Millen}, 793 N.E.2d 335 (Sup. Ct. Mass. 2003)
parent to appoint trust assets back to their adult child any more than a spouse appointing back to their spouse in a SLAT or intervivos QTIP or a child appointing to their parent as beneficiary if they predecease; rather, it’s completely natural.

To quote one recent tax court case:

“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?”179

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

179 Christopher C. Close, et ux. v. Commissioner, TC Memo 2014-25
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.\textsuperscript{180}

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. 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 more dubious circumstances.\textsuperscript{181}

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

\textsuperscript{180} E.g., \textit{T. H. Holman Jr., CA-8, 2010-1 USTC \#60,592, 601 F.3d 763, 770, 772 (2010)}

\textsuperscript{181} 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." \textit{Estate of Monroe v. C.L.R.}, 124 F3d 699 (5th Cir 1997).
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, 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.

i. 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.

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182 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
183 IRC §2523 (lifetime marital gift tax deduction), IRC §2503(b) (annual present interest exclusion from gift tax)
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?

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 Non-Grantor (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{184} 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{185}

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{186} 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{187} This is similar to the recent ruling outlining that only a portion of a GRAT is included in a settlor’s estate under §2036 should they die during the annuity term.\textsuperscript{188} 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{189}

However, such changes risk the IRS arguing that there is a prearrangement with the trustee/trust protector (ergo, never really a complete gift), or that it will simply never be

\textsuperscript{184} Reg. §25.2511-2, Cessation of Donor’s Dominion and Control.
\textsuperscript{185} CCA 2012-08026, in spite of a seemingly contrary treasury regulation at Reg. §25.2511-2(b).
\textsuperscript{186} It would not cause inclusion under §2041, since a settlor/donor cannot create a general power in him/herself
\textsuperscript{187} See Reg. §20.2038-1(a).
\textsuperscript{188} 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{189} Subject, of course, to the three year rule of IRC §2035.
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 retained.\(^{190}\) 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 of the gift) incomplete pursuant to §2511.\(^{191}\)

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.\(^{192}\) 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.

j. **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,

\(^{190}\) Treas. Reg. §20.2038(a)-1 – see further discussion in Part V.f. on page 77, footnote 156

\(^{191}\) Treas. Reg. §25.2511-2; contrast paragraphs (b) “complete”, with (d) “incomplete” – embrace (d), avoid (b)

\(^{192}\) IRC §2503(b)
the entire asset is stepped down to a $600,000 basis. The same occurs even in a separate property state if both die, or if a spouse who is 100 percent owner dies.\textsuperscript{193} 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.\textsuperscript{194}

John can use a \textit{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, absent a GPOA or LPOA triggering estate inclusion at either of their deaths, unless the asset increases in value above the $1,000,000 basis. This preserves the $1,000,000 basis for the trust/family who later inherit, who might convert it to an investment asset and later sell the property. One quirk to the carry over basis rules 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.\textsuperscript{195} 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. 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.

\textbf{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).

\textsuperscript{193} Code Sec. 1014(b)(6).
\textsuperscript{194} IRC § 2040(b).
\textsuperscript{195} IRC § 1015(a)
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.

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 what possibilities families can now avail themselves of with that back stop effectively removed for over 99 percent of the population.
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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196 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.
197 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”.
198 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. 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).

In some states, you can accomplish the same asset protection result with an intervivos QTIP, so that less gift/estate tax exclusion is used, and it could come back to the donor-spouse. In other states, an intervivos 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, intervivos 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

199 Ohio R.C. §5816.01 et seq.
200 Arizona may be an exception. See Ariz. Rev. Stat. 14-10505(E)(3)
201 See footnote 34 for a list of state statutes and further explanation
tax purposes, overriding H as the grantor.\textsuperscript{202} This overrides any provisions or conclusions that would otherwise deem H the grantor under IRC §§671-679, making it a non-grantor trust.\textsuperscript{203} 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.\textsuperscript{204} This may be another area where state law, estate tax and income tax law do not necessarily stride in lock step.

\textbf{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 \textbf{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 \textit{in pari materia}.

\textbf{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.

\footnotesize
\textsuperscript{202} Treas. Reg. §1.671-2(e)(6), Example 9 – thanks to attorney Gary Maddox for correcting a typo and suggesting clarifications to this discussion.
\textsuperscript{203} Treas. Reg. §1.671-2(e)(5)
\textsuperscript{204} 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 \textit{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.

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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.\(^ {205} \) 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).

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

\(^ {205} \) 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.
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 powerholders 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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206 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, as some practitioners fear. 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)

207 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). 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.208 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).209 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).”210 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.

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

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208 Rev. Rul. 73-142
210 PLR 2005-43037
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.

The reverse, removing a GPOA, is a more difficult issue, so any reformation should strongly consider the irrevocable nature of it. Generally, releasing a general power of appointment would trigger gift tax, and could trigger taxation of any IRD. However, in one recent PLR, the IRS allowed a post-mortem court reformation to essentially remove a GPOA without adverse tax effect. I would not count on this result for every post-mortem reformation removing a GPOA, but the PLR is instructive as to how the IRS applies the Supreme Court’s holding in Bosch.

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 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).

While adding a limited lifetime or testamentary LPOA or formula GPOA, consider changing any “all net income” requirement to a more flexible standard that would allow spraying and/or accumulating income, and address capital gains, for better income tax planning (see Part VIII). In a recent PLR, the IRS ruled that such a modification that removed the “all net income” requirement was not a taxable gift, did not trigger gain, nor did it affect

211 IRC §2514
212 PLR 2011-32017, see also PLR 2010-06005 approving reform of a GPOA to an LPOA w/o adverse tax effect
213 For a great summary of the more than 20 various decanting statutes and their characteristics, see http://www.sidley.com/state-decanting-statutes/
the GST zero inclusion ratio.\textsuperscript{214} I believe the giving up of net income was not considered a taxable gift in the PLR because any accumulated income, pursuant to the trust amendment, was payable to and would be included in the beneficiary’s estate. While this somewhat curtailed the GST advantage of removing the “all net income” requirement, it may have allowed high bracket beneficiaries to manipulate state income tax and increase asset protection.

\textbf{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/reformed trusts, that is not to say that amendments may not have other effects. \textit{Beneficiary procurement or even acquiescence to trust amendments may have detrimental tax and asset protection effects}. This is arguably one of the most under-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{215}

The \textit{Sexton} case is instructive here.\textsuperscript{216} \textit{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 7\textsuperscript{th} Circuit confirmed, that the amendment was effective pursuant to the trust and state law, but that \textit{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 had the beneficiary not consented, their argument that the amendment was not a relinquishment/transfer and therefore had no

\textsuperscript{214} PLR 2013-20004, modifications complying with GST grandfathering regs were OK for \textit{allocated} GSTexempt

\textsuperscript{215} 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.

\textsuperscript{216} \textit{Sexton v. U.S.}, 300 F.2d 490 (7th Cir. 1962), cert denied 371 U.S. 820 (1962)
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 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. 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. E.g., mom is lifetime beneficiary of bypass trust, remainder to son. Mom and son agree, pursuant to non-judicial settlement, the trust or other state law, to give mom a GPOA. As stated in discussions of authority cited above, the IRS would probably have to honor this change in property rights at mom’s death if pursuant to state law. However, could son be said to have

218 PLR 201122007, see also similar PLR 8535020
made an incomplete gift by converting his vested remainder interest into a vested remainder interest subject to divestment? Could this trigger §1014(e) if done within one year of mom’s death? As to how much? If the property comes back to son, the “gift” would be to himself (but potentially creating a self-settled trust if appointed to him in trust), but if mom appoints to her son’s children, would this make the son’s tentative de facto gift of his remainder interest by consenting to the GPOA complete? This is mere speculation, and probably makes more than a few readers’ heads spin. Here’s the nutshell – it is safer to avoid this morass of issues with amending actions initiated by an independent trustee or trust protector only.  

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. 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.

If the court order is retroactive nunc pro tunc, as a trust 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.

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 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,

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219 See Gifts by Fiduciaries by Tax Options and Elections, cited and discussed on page 24, footnote 56.
220 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.
221 See discussion in the Uniform Disclaimer of Property Interests Act, §§6-7
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.\footnote{222 Treas. Reg. §26.2601-1(b)(4)(i)(D):}

But as we’ve said before, fewer people are wealthy enough to care about the gift/GST tax much anymore, but there could also be arguments that amendments/reformations not done by the trustee via decanting or court petition or trust protector might not be effective. You cannot create a GPOA for yourself, nor can you create a GPOA if it is exercisable in conjunction with the donor of the power.\footnote{223 IRC §2041(b)} Well, who is the donor of the power in such an instance? Is it still the original settlor, as it would be with a decanting or trust protector power that is essentially exercising a limited fiduciary power of appointment? Perhaps, if the reformation is retroactive. Or, might the IRS claim that a spouse and child, for example, are the donors of the power in such instance? You would be in a better position with a court order stating that such an amendment is merely construing or reforming the trust to comport with the settlor’s original intent by creating the LPOA/GPOA, so that it is more analogous to a decanting/amendment pursuant to the original trust terms. However, there is no clear guidance here.

g. 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 wide discretion, one that is not. 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. 224 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? 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. Perhaps there is a state decanting statute that would clearly apply in such situations, but I have not examined the statutes (twenty-two jurisdictions by last count, which will surely increase).

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

Speaking around the country on this topic, one hears anecdotal evidence of families simply terminating AB trusts where there is no estate tax concern – the question posed to attorneys being “so what if we just terminate the trust?” 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. 225

224 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.”

225 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.
VIII. The Income Tax Efficiency Trust – Ongoing Trust Income Tax Planning Techniques

As mentioned above in Part I, there is another income tax issue after ATRA 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.
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.”226

Qualified retirement income is excluded, as well as wages, self-employment income, active business income or gain from a sale of such a business.227

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).

226 IRC § 1411(c)(1)
227 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).

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228 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.

229 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% (8.8%) times total LTCG ($70,000) = $6,160
(amount of overall LTCG and surtax savings by taxing to beneficiary not trust)

plus

43.4%-28% (15.4%) times STCG ($30,000 -11,950) = $2,780
(amount of STCG and surtax savings from taxing to beneficiary, not trust)

(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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230 IRC §643(a)(3), Treas. Reg. §1.643(a)-3(a)
231 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 (currently $400,000/yr single, $450,000 MFJ taxable income), 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{232} 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{233}

\textsuperscript{232} 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{233} 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. 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”. 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 (BDIT)”s, 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. This is a commonly accepted myth, but understandable, since there

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234 In Subchapter J, Subparts A-D, IRC §641-669, control most traditional trust tax accounting, Subpart E is the grantor trust rules, §671-679.
235 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.
236 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 beneficiary must report the capital gains. It is not optional to report under Subparts A-D of Subchapter J and/or have the trust be liable for the tax.

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238 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 and Jonathan Blattmachr, Mitchell Gans and Alvina Lo’s article at 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).

239 See Uniform Principal and Income Act, §409, §404

240 Treas. Reg. §1.671-3(b)(2)

241 For example, in 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
Treasury Regulations are quite 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.”

Refusing to take the income is not relevant to the analysis, nor is renouncing the right to prior income. Although a withdrawal power is probably effective for §678(a) regardless of a beneficiary’s 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.

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).

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.

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. The son’s wife was to get $10,000/yr, and the son could 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 them).

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242 Treas. Reg. §1.671-2 Applicable Principals
243 Grant v. Commissioner, 174 F.2d 891 (5th Cir. 1949).
244 Generally GPOAs are unaffected by a powerholder’s incapacity, see footnote 69, and §678(a) should follow. Rev. Rul. 67-241
245 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.
246 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
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.”248

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.249

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

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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 inexplicably ignored §678(a)(2),
which may have helped the taxpayer get a pro rated deduction).

248 Id. at 5
249 Campbell v. Commissioner, T.C. Memo 1979-495
income. Accordingly, pursuant to section 678(a)(1), petitioner are deemed to be the owners of the capital gains income from the King Trusts.”

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. 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 prorated accordingly. 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. 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.

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. The most common and potentially valuable benefit, §121, is discussed in its own section below.

250 Id. at 16
251 Or, more accurately, no income to report under Subparts A-D of Subchapter J, but under Subpart E grantor trust 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.
252 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.
253 Goldsby v. Commissioner, T.C. Memo 2006-274
254 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.
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.\(^{255}\) 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.\(^{256}\) 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.\(^{257}\) 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.\(^{258}\)

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,

\[^{255}\text{IRC §179(d)(4), although if the income is going to be earmarked to a specific beneficiary, then a QSST election may solve the issue if an S corp– QSSTs are in many ways de facto §678(a) trusts, see e.g., Treas. Reg. §1.1361-1(j)(8), but the §678(a) solution may be a good solution for an LLC/LP taxed as a partnership. The generous $500,000 expensing provision is temporary- the law is due to revert to $25,000 in 2014, but Congress may extend or modify that amount and there are various bills proposed to do so.}\]

\[^{256}\text{IRC §1361(c)(2)(A) “the following trusts may be shareholders: (i) A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States.” Subpart E of part I of subchapter J is referring to IRC §§671-679, which includes §678(a) of course. PLR 2012-16034 recently followed this, ruling that a beneficiary-grantor trust created via Crummey power qualifies as an S corp shareholder. Conservative practitioners may want to file a QSST election as a “belt and suspenders” approach, but this is a great back up in case that election failed to be properly filed. For most purposes, except perhaps for sale of the stock (where the QSST would no longer be treated as a grantor trust), it is the same for income tax purposes.}\]

\[^{257}\text{This is contrary to unused net operating losses, which a beneficiary “inherits” upon termination under IRC §642(h). There is a good argument that suspended S corp losses are personal and not transferred: IRC §1366(d)(1) and Treas. Reg. §1.1366-2(a)(5)(i)}\]

\[^{258}\text{See IRC §1244, Treas. Reg. §1.671-3(a) and (a)(2)}\]
allowing the tax-exempt assets to stay trapped in trust without requiring withdrawal or 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.259 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”.260 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%.261 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 such 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

260 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.
261 IRC §2514(e). 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 withdraw $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).
Subchapter J, which does not allow tracing of types of income. For example, say a trust 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 shifts taxation of the rent, traditional IRA and taxable interest to the beneficiary. This may cut the rate on that from a 43.4% rate to a likely 15%, 25% or 28% taxed to the beneficiary.

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, though it certainly complicates administration, such as income to a point until his/her taxable income exceeds $400,000/$450,000 top income tax bracket. Remember this also forces a portioning of any expenses, such as investment management/trustee, attorney fees, though directly attributable expenses, such as investment management/trustee, attorney fees, though directly attributable expenses (e.g. real estate taxes on the residence) may go with the §678(a) beneficiary (or non-grantor trust portion, as applicable).262 Any structure with withdrawal rights over only certain types of assets would have issues if the beneficiary were the controlling investment trustee, 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.263

While §678 withdrawal provisions shift the income taxation (and with it, the Medicare “surtaxation”),264 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 clause and/or trust protector might easily cut that off to

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262 Treas. Reg. §1.671-3(a)(2)
263 See Treas. Reg. §1.671-4 for various alternative methods of grantor trust reporting compliance.
264 Treas. Prop. Reg. §1.1411-3(b)(5)
prevent much ongoing damage. An automatic provision is preferred to avoid fraudulent transfer issues, but a trust protector enables modification when no threat is imminent.\textsuperscript{265}

- 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.

- if assets are \textit{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 and/or state creditor lapse protection and if asset protection is desired, contribute it to an IRA/Qualified Plan, life insurance, LLC, DAPT, gifting trust or other protective structure.

Most tax preparers (and many attorneys) are neither educated on these concepts nor prepared to evaluate such trusts, so if \textsection 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. This would also help with any future reformations.

c. \textit{IRC \textsection 678(a) – Seizing the $250,000 capital gains tax exclusion for residence under \textsection 121}

The most common of the tax savings opportunities of 678(a) 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 \textsection 678(a) trust as to that asset upon sale. Such a provision as to residential property \textit{only} avoids many of the negatives of \textsection 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.

\textsuperscript{265} For discussion of fraudulent transfer failures using trust protector/decanting see \textit{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.
Grantor trusts are permitted this exclusion provided the other occupancy requirements are met. The mortgage interest deduction should also be allowed. 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. A mere right to occupy and use the property is 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.

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, and state and local income taxes at up to 13.3%, there could easily be a tax cost of over $100,000. Surviving spouses may remarry and may own 50% outside of the trust, so it may not just be $250,000, but $500,000 excluded.

Trustees must normally make property productive of income, but trusts routinely permit the trustee to invest in a residence for a beneficiary or retain a contributed residence and specific language should be considered on this point.

d. Application to Special Needs Trusts

It is probably stating the obvious, but a §678(a) power would not work in a special needs trust scenario. 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 higher income taxation among the family unit – not only would a special needs beneficiary getting a K-1 be in

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266 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, they should apply to extend the exclusion if all the capital gains are subject to withdraw. This is perfectly consistent with Treas. Reg. §1.671-3(a)(2) and §678(a).
267 Treas. Reg. §1.163-1(b) (equitable ownership sufficient)
268 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 the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the trust will be treated as if made by the taxpayer. See also PLR 1999-12026 (revocable trust eligible – why someone bothered with a PLR for that is unclear).
269 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)
270 Uniform Prudent Investor Act (Restatement of Trusts, 3rd), §181
a lower bracket typically, but qualifying non-grantor trusts for special needs beneficiaries (a “qualified disability trust”) even receive an additional personal tax exemption.271

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.272 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 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.

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271 IRC §642(b)(2)(C), tied to personal exemption, $3950 in 2014, rather than $100 for typical complex trusts.
272 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.”
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 of 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.

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273 Exceptions may be necessary for QTIP beneficiaries for IRC §2519 reasons, as discussed in Part VIII.k, or grantor-CLT trust beneficiaries, which may have self-dealing issues.
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 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

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274 See Treas. Reg. §1.643(a)-3(a) for this default
275 IRC § 643(a)(3)
276 Treas. Reg. 1.643(a)-3(b)
might even give some cover in case the trustee failed to be consistent.\textsuperscript{277} For new estates and trusts, this is quite easy. For an existing trust, there is a question whether it can change this practice when in prior years it has been consistently NOT treating capital gains as part of a beneficiary’s distribution.\textsuperscript{278} Potential remedies of amendments and decanting will be further discussed below.

The third method, (b)(3), is 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?

In lieu of tracing, the third method also allows capital gains to be part of DNI if the trustee 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 in this manner. 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).

\textsuperscript{277} 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);

\textsuperscript{278} 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????

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 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 document. Perhaps it would be more certain if the trust document specifically required or at least permitted the trustee to consider capital gains, something like “in exercising the trustee’s discretion to distribute principal, my trustee may [shall?] consider any capital gains realized by the trust as a relevant factor in determining any amount pursuant to its discretionary decision.” Detractors might say that using “shall” restricts the trustee’s ability to NOT consider capital gains in future years if (b)(3) were desired to be avoided. A non-judicial (private) settlement agreement may be a good solution here to add such a sentence.

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.”

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279 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.

280 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 852-3rd, Acker, A67 and authorities cited therein.
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, 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).\footnote{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 not a beneficiary nor “related or subordinate” (as those terms are defined in IRC § 672) to any beneficiary of a trust may reallocate capital gains taxable 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 otherwise cause a Medicare surtax or short-term capital gains rates in excess of the net additional tax effect of a reallocation on a beneficiary’s taxes.”}

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.
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. 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 easier, and promising if the trust has language requiring consideration of capital gains in the distribution decision, but is still uncertain for my tastes as far as how the IRS will actually police that “utilization”.

Problems 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 new treatment of capital gains as inconsistent with prior practice. After all, trustees don’t typically get a completely new EIN for such changes. Therefore, practitioners might seek a private letter ruling to adapt existing trusts that have a history of not treating capital gains as part of distributions, or use one of the other methods mentioned herein, such as changing the principal and income scheme.

Impact of changing tax burden on beneficiary distributions

If capital gains are considered part of Barbara’s distribution and ordinary non-grantor trust rules are applied, the $40,000 of accounting income and the $75,000 of principal distribution is also taxed to her and 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 $11,950. Thus, the 43.4%/23.8% highest marginal trust tax rate is
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, 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” 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, 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-making. In the latter cases, a professional and independent trustee or co-trustee should be considered to properly exploit this flexibility. Professional trustees HAVE to paper the file, for the 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.\(^{282}\) Or, probably better in many ways, the settlor may give the surviving spouse or another party a limited lifetime power of appointment.\(^{283}\) 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 or collateral powerholder to spray $80,000 to her children (or 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.\(^{284}\) 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

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\(^{282}\) 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.

\(^{283}\) 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 nonadverse party.

\(^{284}\) 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.
IRA is involved, which would suggest using separate trusts or subtrusts). 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 rather compelling rationale to interpret the regulation in such a manner. If the PLR and more importantly, such an interpretation of the regulation can be relied on, could this open up tax shifting opportunities?

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285 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.

286 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(b)-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 and/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(b)-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%/5000 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(b)-7(h)
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. For example, a power only exercisable with the consent of 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

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287 See PLR 90344004 – “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 denominator of which is the total of trust corpus from which the withdrawal could be made. Discretionary distributions made by the trustee from corpus will be treated as coming from both the portion of corpus which the beneficiary is treated as owning and from the portion which she is not treated as owning in the same ratio as the fraction mentioned above.” Have fun with that calculation! This kind of §678(a) trust is the worst of all worlds.
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.\textsuperscript{288} Even if the kiddie tax applied to use Barbara’s highest income tax bracket, the 3.8% surtax is probably avoided, \textit{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 \textit{dispositions} of a QTIP as a transfer of the entire interest for gift tax purposes.\textsuperscript{289} 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.

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.\textsuperscript{290}

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 in trusts (whether they are simply a power to appoint to self only, as many QTIPs do, or to self and others), at least consider the above §678(a) avoidance technique to avoid accounting nightmares.

\textsuperscript{288} Treas. Reg. §1.643(a)-3(b)(2)
\textsuperscript{289} IRC §2519(a)
\textsuperscript{290} IRC §2044 pulls any QTIP trust back into the surviving spouse’s estate for inclusion, allowing §1014 step up
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.. 

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.

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. It can carry out capital gains allocated to corpus. It can carry out IRD.

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. Other states allow individual charitable deductions, but they are subject to Pease limitation phase outs. Saving another 5-10% state income tax

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291 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

292 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 contribution as paid during such taxable year.” See also Treas. Reg. §1.642(c)-1(b) and PLR 2013-43002, which granted 9100 relief to permit election even after the due date w/extensions had passed.

293 Treas. Prop. Reg. §1.1411-3(e)(2) and Treas. Prop. Reg. §1.1411-3(f) Ex. 2

294 IRC §643(a)(3)(B)

295 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.”

296 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

297 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,
can be substantial state income tax savings, even if there is state-source income, like selling a business or real estate located in state.\textsuperscript{298} 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 independent of income tax consequences.”\textsuperscript{299} 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.\textsuperscript{300} 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.\textsuperscript{301} 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

\textsuperscript{298} 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 \url{www.tax.ohio.gov}, \url{http://www.tax.ny.gov/pdf/2012/inc/it201i_2012.pdf}

\textsuperscript{299} Treas. Reg. §1.642(c)-3(b)(2)

\textsuperscript{300} Treas. Reg. §1.642(c)-3(b)(2), Example 1 shows mere ordering rules to be insufficient

\textsuperscript{301} 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.
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 federal income taxation under §501(a) as an organization described in §501(c)(3) and also is described in al of §§ 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).  

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).  

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302 Treas. Reg. §1.662(b)-2, Example 1, specifically paragraph (e)  
303 PLR 2012-25004; similar PLR 2009-06008 allowed the 642(c) deduction through exercise of an LPOA  
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.305

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 it had appreciated to $100,000 by the time of distribution to charity, the deduction under IRC §642(c) is probably limited to $80,000, since only $80,000 came from gross income.306

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.307 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.308 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

305 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 (1999)
306 IRS CCA Memo 2010-42023, while it may be debatable, the memo is persuasive in its reasoning
307 IRC §681(a), Treas. Reg. §1.642(c)-3(d) and (e)
308 Treas. Reg. §1.681(a)-2(a) and (b)(3) – it’s a convoluted statute, best understood reading examples in (c)
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.
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/grantor CLT.309

Let’s start with a DING example that does not even rely on state income tax savings.310 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


310 I will 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 could also have a “NING” or “OING” for Nevada or Ohio, or use any other DAPT state (VA, MO, AK, UT, etc). NV, OH and DE statutes all permit the settlor to retain lifetime limited powers of appointment, which were seemingly a factor in the more recent PLRs. Not all states 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 1040, to the 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. Not only that but many taxpayers, even many higher income taxpayers, do not even itemize deductions.

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. 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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311 Pease limitations do not apply to non-grantor trusts and estates. IRC §68(e)
312 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.
313 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)
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”).

Can these be combined with a DING, so as 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?

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.

Can you combine these into a DING-CRUT, with the DING as the beneficiary of the CRUT? Yes - 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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314 As to timing of transfers, see Rev. Rul. 78-197, 1978-1 CB 83 discussion and acquiescence to Palmer v. Commissioner, 62 T.C. 684 (1974), aff'd on another issue, 523 F.2d 1308 (8th Cir. 1975)
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?315 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, better compatibility with disclaimer planning, better ongoing income tax treatment for the trust and spouse overall and

315 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.
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 amount 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, 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, 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. With many people expecting inflation to eventually increase with the recently expanded money supply (quantitative easing), realize that higher inflation over time

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316 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)

317 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 On the $28,000,000 Mistake: Underestimating the Value of a Bypass Trust and Overestimating the Value of Spousal Estate Tax Exclusion Portability, Steve Leimberg’s Estate Planning Newsletter #2061, concluding savings to be...$28 million. While I may have used different assumptions, the general thrust of the article/spreadsheets is in the right direction and makes a powerful point.
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.318

There are some narrow situations in which a marital trust will generate better estate tax results than an OBIT.319 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 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. 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/OBIT

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318 Discussed in Part I, see IRC §2207A and your state equivalent, such as Ohio R.C. §2113.86(I)
319 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)
can be amended by decanting, non-judicial settlement, trust protector, trustee amendment, UTC provision, etc. – a marital trust has to be extraordinarily careful NOT to allow any amendments, however well meaning, else the marital deduction will be denied.\textsuperscript{320} 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 with ample precedent and guidance, there is only one reported case construing the Delaware Tax Trap. The best of all worlds would be to have some variant of state law that clearly allows triggering the Delaware Tax Trap by creating successive \textit{limited} powers of appointment, as the draft law in the Appendix attempts to move forward.

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.\textsuperscript{321}

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 yourselves” 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.

\textsuperscript{320} 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.\textsuperscript{321} 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?
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- 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

(how powers of appointment are included in gross estate, sections bold/italicized are sections discussed by author, [bracketed comments inserted by author])

(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
[omitted – but important if you have an old trust]
(2) Powers created after 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 includable 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 includable 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.

(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.
“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.

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322 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 devotion; 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

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[Note, throughout the sample language you will note my preference for single rather than joint trusts. For those in community property states or who otherwise use joint trusts, some language might be adapted for joint trusts.]

Sample Language for Formula GPOA for Bypass (Family, Credit Shelter) Trust

Subject to the remaining provisions of this Section, my spouse has the testamentary power to appoint a certain portion of assets, be they allocable to principal or undistributed income, remaining in the Family Trust at my spouse’s death. This power shall apply differently or not at all to different assets. The potentially appointive assets shall be constrained and limited as follows:

1) **General Power of Appointment** – My spouse may appoint certain assets of the Family Trust to my spouse’s creditors [you could alternatively say “my spouse’s probate estate” to the same effect, but my strong preference would be to say “creditors” to better exclude a new wife/husband or others “undesirable” to the settlor as potential beneficiary – if a power holder can appoint to a power holder or a power holder’s estate, this is construed to include ANYONE, including new spouse, charity, etc, whereas if a power holder can appoint to creditors only, the permissible appointees are only bona fide creditors] or to my descendants in such amounts and subject to such terms, including trusts, as my spouse directs. [alternatively, this may be broader and include other uncles, cousins, friends, charities, etc] [it is highly recommended that you require a non-adverse party consent, which might apply only to appointment to creditors, or, some clients may also wish it to apply to other non-equal appointments as well – e.g. “my spouse may only appoint to his or her creditors with the consent of __________ and/or __________” (these persons or entities cannot be a beneficiary or “adverse party” – an independent trust company for instance, may be non-adverse), or “Any appointment that is other than equal to my children or to trusts for my children, per stirpes, may only be made with the consent of __________].” [Alternate #1 definition of potentially appointive assets] The assets subject to this general power of appointment shall be all assets of the Family Trust, excluding:

- (i) all property that constitutes income in respect of a decedent (IRD), except employer securities previously received in a lump sum distribution from a qualified plan containing net unrealized appreciation (NUA) that would also be IRD pursuant to IRC §402 and §1014(c). Only such employer securities that have unrealized gains post-lump sum distribution are eligible to be an appointive asset pursuant to this paragraph, those without unrealized gains post-distribution are not eligible;

- (ii) Roth IRA accounts or Roth variants of other retirement plans such as 403(b), 457(b), or 401(k) plan accounts;

- (iii) 529 Plan Accounts or Coverdell Education Savings Accounts (ESAs);

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(iv) all property that has a cost basis for federal income tax purposes that is greater than or equal to the fair market value of the property at the time of my spouse’s death;

(v) all life insurance policy or annuity death benefit proceeds owned by and payable to the trust as a result of my spouse’s death.

After eliminating the above described assets from the appointive assets subject to this general power of appointment, if such remaining assets’ inclusion in my spouse’s taxable estate for federal and/or state estate tax purposes would not increase my spouse’s federal or state estate or generation skipping transfer tax liability, **assuming any marital or charitable deduction is denied to my spouse’s estate**, the general power described above shall apply to all remaining assets of the Family Trust.

[Alternate version of above without the charitable/marital reduction] - After eliminating the above described assets from the appointive assets subject to this general power of appointment, if such remaining assets’ inclusion in my spouse’s taxable estate for federal and/or state estate tax purposes would not increase my spouse’s federal or state estate or generation skipping transfer tax liability, the general power described above shall apply to all remaining assets of the Family Trust.

[Rather than starting with all assets and then excluding certain assets, as above, it is probably preferable and simpler to do the opposite – start with no assets and then define the potential assets eligible to be appointive assets, since new tax categories of assets may be created in the future, or frankly, I may have just omitted one that should have been excluded. Here is a potentially better variation:

[Alternate #2 definition of potentially appointive assets] The assets potentially subject to this general power of appointment shall only be those assets of the Family Trust whose tax basis would increase in value pursuant to IRC §1014 if included in the powerholder’s estate.

However, should such inclusion otherwise result in federal or state estate or generation skipping transfer tax liability (even if any marital/charitable deduction were also denied), the appointive assets subject to this general power of appointment shall be further limited, and apply or not apply to each remaining asset of the trust not previously excluded as a potential appointive asset above in the following order.

The power shall apply to the asset with the largest percentage of difference between fair market value at the time of the powerholder’s death and the cost basis immediately prior to the powerholder’s death first, cascading in turn to each subsequent asset with the next largest percentage difference between fair market value and cost basis (e.g. an asset with basis of $10, FMV of $100 would have a “percentage of difference” of 90/100, or 90%).

[Here is a clause that would give a preference to depreciable property and collectibles, which would generally be more valuable for beneficiaries – I did not differentiate between 5 year, 27.5 year, 39 year property, etc, someone more detailed than I might craft a version that does:
[Alternate] In ordering these trust assets, and purely for the purpose of ordering which assets are appointive assets, depreciable assets shall be deemed to have a percentage of difference 50% higher and collectible assets 30% higher. To illustrate, if the trust owns a building with a basis of $100,000 and FMV DOD $200,000, stock with a basis of $90,000 and FMV $200,000 and art with a basis of $110,000 and FMV $200,000, the percentage of difference for purposes of this paragraph shall be (50% times 1.5) 75%, 55% and (45% times 1.3) 58.5% respectively, thus the power of appointment shall apply first to the building, then to the artwork and finally to the stock.] For purposes of this paragraph, entities taxed as a partnership that hold depreciable assets shall be considered depreciable assets, regardless of whether an election is made under IRC §754.

[Alternatively, and this gets even more complex, you could try something that tries to be even more targeted to the tax effect by looking to the tax effect upon the trustee or even the beneficiaries (more accurate, but much more complicated).

[Alternate] The power shall first apply to the asset which, if the basis were increased to the powerholder’s date of death value, would reduce the hypothetical federal [I would omit state for ease of calculation, but some might want to include it] income tax, including the net investment income Medicare surtax, the most as a percentage of overall value if all of the potentially appointable assets of this trust were sold immediately after my spouse’s death. The calculation of such hypothetical federal income tax which would be recognized shall be determined under the highest bracket without consideration of any other income tax deductions, credits, exemptions, loss carry forwards or carry backs, which would otherwise be recognized on the filing of a fiduciary income tax return. For illustration, assume the trust had an IRA, an annuity, cash, stock with a basis of $100,000, FMV $90,000, a building with basis $100,000, FMV $200,000 ($70,000 basis reduced due to depreciation), P&G stock basis $120,000, FMV $230,000 and artwork with basis $130,000, FMV $220,000. The first four categories of assets would be disregarded as not even potentially appointable. The trustee would calculate the hypothetical tax on the remaining three assets as follows: building ($60,000 times 28.8% (25% depreciation recapture + surtax) plus $40,000 times 23.8% = $17,280 + $9,520= $26,800 hypothetical tax; P&G stock $110,000 times 23.8% (20% LTCG rate plus 3.8% surtax = $26,180; artwork ($90,000 times 31.8% (28% collectibles rate plus surtax) = $28,620. These hypothetical tax numbers would then be divided by the FMV to determine which asset would hypothetically benefit the most from a basis increase: $26,800/$200,000 = 13.4%; $26,180/$230,000 = 11.38%; $28,620/$220,000 = 13.01%. Accordingly, the power shall apply to the building first, then the artwork, then the stock.]

[note: my own preference would be to use a simple artificial grossing up of the difference for depreciable property (less so collectibles), because unlike other assets, added basis to depreciable property usually benefits taxpayers whether the property is sold or not.]

Once an asset’s (or group of assets’) inclusion as appointive assets would otherwise cause an increase in my spouse’s federal or state estate tax liability [assuming the marital or charitable deduction were denied the estate], the power to appoint them shall be limited to that fraction or percentage that would not cause any estate tax liability. Upon reaching
this limit, all other assets are excluded from this general power of appointment [and shall be subject to the limited power of appointment described in paragraph 2 below].

Property with different cost basis for different lots or purchases shall be considered completely separate property for this purpose (e.g. 100 shares of ABC stock bought at $350/sh shall be considered different from 100 shares bought at $500/sh a year later), and may be divided or fractionalized accordingly.

Property that is employer securities received as a lump sum distribution from a retirement plan with net unrealized appreciation shall consider said net unrealized appreciation for this purpose (e.g. 1000 shares of P&G stock with a tax basis of $50,000, net unrealized appreciation of $20,000 and fair market value of $85,000 shall consider the basis to be $70,000 for purposes of application of this paragraph. If the stock’s value were equal to or less than $70,000, it would accordingly not be an appointive asset subject to this GPOA).

For purposes of illustrating the intent of this Paragraph 1, if $50,000 could be added to my spouse’s estate prior to application of this Paragraph 1 without causing state or federal estate or generation skipping transfer tax, and the asset with the largest percentage difference between cost basis and fair market value is 100 shares of ABC stock with a basis of $35,000 and fair market value of $100,000, then this general power of appointment shall extend to only 50 shares from that lot of stock.

A material purpose of this paragraph [section XX.X] is to grant my spouse a general power of appointment as defined under IRC §2041 limited in such a way as to maximize the income tax basis increase under IRC §1014 of the property held in the Family Trust without increasing my spouse’s federal or state estate or generation skipping transfer tax, and without subjecting substantial trust assets to my spouse’s creditors should my spouse’s estate be insolvent, so as to provide the maximum benefit to our ultimate beneficiaries. This trust may accordingly be amended or decanted pursuant to applicable state law [or, reference a trust protector or independent trustee amendment clause if there is one already in the trust to permit amendments] to comply with this intended purpose should:

a) IRC §1014, §2041 or other applicable tax law be materially changed;
b) the state, federal or foreign estate or inheritance tax applicable to my spouse’s estate be materially changed;
c) my spouse remarry and reside in a jurisdiction with a spousal elective share definition that would otherwise include appointive assets subject to a third party created testamentary general power of appointment, without having a valid pre or post nuptial agreement that would otherwise exclude these trust assets;
d) my spouse’s projected estate appear likely to be insolvent and my spouse resides in a state which does not protect assets subject to a testamentary general power of appointment from a decedent’s or decedent’s estate’s creditors;
e) any improved formula yield superior tax results for the beneficiaries; or three
f) any other situation arise which would frustrate the intention of this paragraph.

324 Lest a practitioner be worried that the IRS could make some crazy argument that a power cannot be changed from limited to general or vice versa under state law, the Restatement is clear that a power’s status as limited or general depends on the actual situation at any given time. See Rest. Property, Third, § 17.3, comment d.
2) **Limited Power of Appointment** [note, there is no tax need for an LPOA, it is entirely dependent on whether a settlor wants to grant flexibility of distribution] - My spouse may appoint all other assets not subject to the general power of appointment in paragraph 1 above or the exclusion in paragraph 3 below to my descendants or to any trust primarily therefore, which shall specifically exclude my spouse, my spouse’s estate, my spouse’s creditors, or creditors of my spouse’s estate. [This may be in such amounts or shares as my spouse shall determine, including all to one descendant to the exclusion of all others]. [Alternatively, many clients may want to make this much more specific (e.g. descendants only unless all predecease, or to descendants and/or trusts therefore equally), or even require a non-adverse party’s consent, for non-tax reasons (to prevent disinheriting one child, for example) Further note – if IRA/Qualified Plan assets were payable to the trust, and there is no conduit provision, then further limitations are recommended – see separate outline/checklist on IRA and see-through trust issues.

3) **Proceeds of life insurance held by the trust insuring the life of my spouse** – My spouse shall not, however, have any power of appointment (limited or general) over any proceeds of life insurance owned by the trust and payable to the trust that insures the life of my spouse [I am skeptical that this is needed at all – a testamentary POA over the trust assets may not be an incident of ownership pursuant to IRC §2042 of a policy owned by the trust. And, few bypass trusts would own life insurance on the surviving spouse – avoiding IRC §2042 would preclude the surviving spouse acting as trustee as well. However, I included this in an abundance of caution pending research. Also, you could have a scenario where 2042 inclusion would be moot (ie not cause estate tax), a nuance which is not accounted for in this paragraph. Theoretically, someone may want their spouse to be able to appoint life insurance proceeds as well if no additional tax is caused]

**Form and Method of Exercise of Any Power of Appointment** -

My spouse has the exclusive right to exercise the above limited and general powers of appointment. [However, an agent for my spouse under a Power of Attorney or a court appointed guardian may also exercise the testamentary power of appointment under the same conditions as noted above.] The above powers may be exercised by specific reference to this power of appointment in a Will, revocable living trust, or other written instrument that is witnessed or notarized. [Many attorneys limit this only to wills, such as “may be exercised only by a will specifically referring to this power of appointment“]. Should multiple attempts to exercise conflict, the last executed document shall control. The trustee may rely on a power of appointment exercised via Will not yet admitted to probate, but the trustee may in its discretion insist that any Will containing such exercise be admitted to probate or filed for public record. In determining whether a testamentary power of appointment has or has not been exercised, the trustee may rely on its knowledge of any exercise or lack thereof and proceed accordingly without liability (except for actions taken in bad faith), in the absence of
actual knowledge to the contrary made known within three months after the powerholder’s death.325

Unless appointive assets are otherwise curtailed, such appointments may be in cash or in kind and may direct specific property to any one or more of the permitted objects of the power, either in trust, or by creating life estates or other restrictions or conditions for any one or more permitted objects of the power and remainders to other permitted objects.

**Conditional expansion of permissible appointees if appointments made in further trust primarily for permitted appointees** [note, something like this paragraph should be considered if there is not a broad class of appointees, for instance, only to descendants under Paragraph 2 or only to descendants or creditor in Paragraph 1]. If my spouse makes appointment in trust for any of the permitted appointees as noted above, such that a permitted appointee or appointees are the primary beneficiary or beneficiaries during their lifetimes, then a permitted appointee may in turn be given a broad lifetime or testamentary, limited or general power of appointment, permitted appointees of which may include charities, creditors or other parties, even if such parties were not in the original class of permitted appointees. In addition, the remaindermen need not be in the initial class of permissible appointees. For example, my spouse may appoint to a trust primarily for my child for my child’s lifetime, granting my child a broad lifetime limited power of appointment and/or testamentary powers of appointment similar to this section, and the remainder beneficiary upon my child’s death may be a charity or spouse of a child. [strongly consider using something like this unless someone demands that grandchildren, for example, be fully vested, not subject to divestment by a child’s exercise of a POA or otherwise (in that case, you might modify this further). This clause allows further LPOA/GPOA OBIT language to harvest basis for the next generation, allows further spray capabilities via LLPOA for better income tax planning, better asset protection if the primary beneficiary is frozen out, etc. The Restatement of Property, 3d, Donative Transfers, §19.2 is clear that appointments to non-permitted appointees may be voided as a fraud upon the power, but what if later remaindermen, spray beneficiaries, etc are not among initially permitted appointees? In most states, but not all, a

325 States may also have indemnification statutes to enable trustees to move on if there is no will filed/knowledge of exercise – see, e.g. Washington statute RCW 11.95.060(2), some language from which you may consider parroting in your document: “Unless the person holding the property subject to the power has within six months after the holder’s death received written notice that the powerholder’s last will has been admitted to probate or an adjudication of testacy has been entered with respect to the powerholder’s last will in some jurisdiction, the person may, until the time the notice is received, transfer the property subject to appointment on the basis that the power has not been effectively exercised. The person holding the property shall not incur liability to anyone for transfers so made if the person had no knowledge that the power had been exercised and had made a reasonable effort to determine if the power had been exercised. A testamentary residuary clause which does not manifest an intent to exercise a power is not deemed the exercise of a testamentary power.” You might add an example of intent – it is not uncommon for a will clause to read “I hereby appoint any and all assets over which I have a power of appointment to...” – this inevitably leads to litigation as to whether this is specific enough to trigger a POA – states/courts may differ. Ohio has a statute requiring a POA appointment by will to be specific, but has no parallel statute regarding trusts/deeds.
POA that can distribute outright or to a permissive appointee in trust can also grant that same appointee a broad POA in the appointive trust under the theory that the beneficiary could have been granted outright ownership. E.g. Washington statute RCW 11.95.060. However, unless you know for certain your client’s residency and state law on this issue, it safest to expressly permit it. See e.g., 25 Del. Code 505, which is mostly positive, but still has flaws re LPOAs - http://codes.lp.findlaw.com/decode/25/5/505]. Here is a citation that will shock readers, and why you should consider something along the lines of above, or a variation: “An appointment by the donee [powerholder] of a special power to one who is not a member of the class is ineffective, at least to that extent. Thus, a power to appoint among the testator’s children or their heirs upon such terms and conditions as the donee [powerholder] may direct does not authorize an appointment to the children for life, with the remainder to their children.”326

Any assets not so appointed under paragraph 1 or 2 above shall pass according to the takers in default of appointment clause below. All values determined for purposes of this Section shall be as finally determined for federal estate tax purposes as of my spouse’s death. My trustee may rely on values obtained from my spouse’s executor (or trustee, if no executor is appointed) used for any state or federal estate tax filing. Should assets later be determined upon audit or amended return to be higher or lower than initially determined, the trustee is absolved from liability for having transferred items to any impermissible appointee via General Power of Appointment in reliance on the above data. However, any impermissible appointees shall hold such funds in constructive trust for those appointees of any limited power of appointment or takers in default who would have otherwise received the assets.

In Pari Materia – In the event that my surviving spouse is a beneficiary of another trust with a similar formula power of appointment provision, whether with myself or another party as settlor, this section shall be read together with the like section in the other trust as if the two trusts subject to the formula general power of appointment were one trust so that under no circumstance could such formulas ignore the other so as to cause my spouse’s total

326 Scott and Ascher on Trusts, 5th Edition, ¶ 3.1.2 Exercise of Power of Appointment, citing In re Dohrman (Matter of Fiske), 195 Misc. 1017, a case where a widow’s husband had granted her the power to appoint in trust for children upon her own “terms and conditions”, but she appointed in trust for children with their issue as vested remainder (ie children had no POA). The children objected, claiming that the power to leave to them in trust was valid, but that the vesting of the remainder in their descendants was invalid because their issue were not permissible appointees – the court agreed with the children, and the children took the assets subject to the life terms, but had free reign over the remainder interest to leave to spouse, charity, whomever at their deaths—presumably the remainder would thus be in their estates, but it essentially gave them a GPOA. Surprise! I doubt most practitioners would catch the import of a clause similar to this case. Examine any trust that was funded with a specific clause like this, perhaps you have an argument for inclusion (which may NOT be desired for larger estates, with loss assets, etc). Note that this case may be decided slightly differently if under Ca Probate Code §674 or a state embracing the Restatement 3d Property, Donative Transfers §19.12(c)(a change from 2nd restatement), which permits appointing to a permissible appointee’s issue in the event the appointee predeceases, under a quasi anti-lapse theory, even for non-relatives. Restatement (First) of Property §359(2): “The donee of a special power can effectvely exercise it by creating in an object an interest for life and a special power to appoint among persons all of whom are objects of the original power, unless the donor manifests a contrary intent.”.
appointive assets under multiple general powers of appointment to create estate inclusion resulting in state or federal estate or generation skipping transfer tax.

**Coordination with and Reliance upon Powerholder’s Executor**
The trustee shall rely on a written statement, which may be in the form of a draft federal or state estate tax return, from the personal representative (executor) of the powerholder’s estate as to the size of the powerholder’s taxable estate (determined, as mentioned above, without regard to any marital or charitable deduction), including available applicable exclusion amount. If no personal representative is appointed, such a statement or statements may be obtained from the trustee of the powerholder’s living trust, or other party considered a statutory executor under IRC §2203.

**Note #1** – GST/Dynastic - this language may be adapted to apply to non-spousal powerholders, of course, and some of this may be adapted and incorporated into the exercising instrument wherever a limited power of appointment is used to trigger the Delaware Tax Trap (see later sample clauses). The *above formula may be adapted to apply to the extent of available GST exclusion* rather than simply to the extent that any appointment does not cause GST tax. See the next sample clause for an alternate version, with additional commentary and pros and cons of that variation.

**Note #2** – Alternate Valuation Date - AVD is not addressed above. In theory, an AVD could be addressed to tweak basis further in rare situations. AVD is only available when the estate tax is reduced. I did not address this to simplify administration (and my drafting :-)) – to address AVD would require delaying determination of the value of the power of appointment by six months and potentially complicate matters. I may address a variation of this in future iterations or presentations. Example: Jane, a surviving spouse and beneficiary of an OBIT established by her late husband, dies with a $6 million estate of her own (thus, she has no AEA and therefore no GPOA over the OBIT) – but the market crashes and 6 months later those same assets are $4.5 million. The OBIT may therefore exploit $0.75 million of Jane’s remaining applicable exclusion amount (assuming no DSUEA, $5.25 AEA), but the language above uses DOD values only, which may still have some benefit, but would not be optimal. Can a GPOA simply be delayed (probably, see page 28 and Treas. Reg §20.2041-3(b)), and can it be applied to assets based on a value six months later? Probably - I welcome any comments or suggestions here.

**Note #3** – Indemnifying trustee for administration of assets between the date of death and determination of exercise of power of appointment. When the surviving spouse/powerholder dies, it may be months before the trustee knows the existence of the POA’s exercise, much less the exact value of the surviving spouse’s net estate (and the value of any marital/charitable deductions). If the GPOA applies to a piece of real estate, and the trustee in good faith sells the real estate after death, then the GPOA should probably apply to cash traced to the sale.
Note #4 – There is no accounting for debts/liens/encumbrances in the above language. Most bypass trusts are not leveraged, but you may have residence with a mortgage, a margin account, or maybe even intra-family loans to the bypass. Future versions of this language may add provisions to account for “net value after debt” for those situations, which are not an issue when someone has a POA over an entire trust. It should not be an issue in the above language if a lien is tied to an asset. For example, if there is $1 million available exclusion and the most appreciated asset is a $1.5 million building with a $500,000 lien, the entire building may still be appointed, subject to the accompanying debt, because the net amount transferred pursuant to the GPOA would be $1 million. I don’t think additional language is needed to handle that. However, debt situations could be problematic when the debt is not associated with or a lien against a particular asset.

Note #5 (FAQ) – Common questions at CLEs: Does exercising a POA via Will require probate of the will, or if exercised, subject it to probate? A: No. A POA can be validly exercised without a Will being admitted to probate, unless the Will specifically requires, but a purported Will rejected by the Probate Court as invalid will not validly exercise a POA. Exercise of a POA by Will does not subject appointive assets to probate.

None of this language is warranted or may be relied on in any way – nor is it legal advice that can be relied upon for penalty protection. Use at your own risk. Any constructive criticism appreciated.

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Thanks to Ohio attorney Brian Layman (www.laymandatri.com) for provided substantial constructive feedback on this clause, and Ohio attorney Andy Richner for providing substantial feedback on Part II of this article and California attorney Terence Nunan for sharing his article and sample formula GPOA clauses.

327 Restatement, Property, 2nd §
Sample Language for Formula GPOA for Bypass (Family, Credit Shelter) Trust –
Alternate version tracking available GST exclusion rather than available AEA (to maximize basis increase ONLY to the extent of available GST exclusion)

Subject to the remaining provisions of this Section, my spouse has the testamentary power to appoint a certain portion of assets remaining in the Family Trust at my spouse’s death. This power shall apply differently or not at all to different assets. The potentially appointive assets shall be constrained and limited as follows:

4) General Power of Appointment – My spouse may appoint certain assets of the Family Trust to my spouse’s creditors or to my descendants in such amounts and subject to such terms, including trusts, as my spouse directs. The assets potentially subject to this general power of appointment shall only include assets of the Family Trust whose tax basis would increase in value pursuant to IRC §1014 if included in the powerholder’s estate.

However, should such inclusion otherwise result in federal or state estate or generation skipping transfer tax liability (even if any marital/charitable deduction were also denied), or exceed my spouse’s available generation skipping transfer tax exemption such that an appointment of potentially appointive assets as defined above could cause an GST inclusion ratio of an appointive trust to increase, the appointive assets subject to this general power of appointment shall be further limited, and apply or not apply to each remaining asset of the trust not previously excluded as a potential appointive asset above in the following order. Whether my spouse actually appoints to a trust that would benefit from GST exclusion is completely irrelevant to determining whether a general power of appointment applies under this paragraph.

INSERT AN ORDERING PARAGRAPH HERE, SEE SAMPLES IN PRIOR SAMPLE CLAUSE

Once an asset’s (or group of assets’) inclusion as appointive assets would otherwise cause an increase in my spouse’s federal or state estate tax liability [assuming the marital or charitable deduction were denied the estate], or go beyond my spouse’s available GST exemption, the power to appoint them shall be limited to that fraction or percentage that would not cause any estate tax liability or go beyond any available GST exclusion. Upon reaching this limit, all other assets are excluded from this general power of appointment.

Note – Often, one would have the same or greater GST exclusion as estate/gift exclusion, but not always, especially with the new DSUE/portability – also consider someone who used annual exclusion Crummey gifts and allocated GST exclusion. Thus, the above formula is adapted to apply to the extent of available GST exclusion rather than simply to the extent that any appointment does not cause GST tax. I did not address this in the first version because most couples and their children would want the second basis step up even if it caused portions of assets to go to a GST non-exempt trust, but I could imagine scenarios where a client may prefer to preserve the maximum GST exemption more than garner a second step up in basis (e.g. child is wealthy themselves, terminally ill, etc). For example, surviving spouse has $6 million AEA ($5.25 Million BEA plus $0.75 million DSUE) and $4.5 million GST exclusion.
($5.25 million GST minus $0.75 million due to GST allocations to Crummey trusts) and a $3 million net estate – the formula above could be adapted to cap the GPOA at $1.5 million in lieu of $3 million, which would lose a basis increase over $1.5 million, but allow $1.5 million in the bypass to continue to be GST exempt (if it is a dynasty trust).

Which is preferred? If the children are only moderately wealthy, or wealthy and charitably inclined, or spendthrifts, they would not get any benefit from the additional trust funds being exempt from their estate via GST exemption, or perhaps they can easily use Crummey/IGTs/GRATs etc to avoid tax or simply spend down the GST non-exempt trust assets first, as is normally encouraged in trust drafting/administration. If the child or children have taxable estates themselves and are not charitably inclined, the calculation is much more complicated – is saving 40% in estate tax a generation from now better than saving 20-35% income tax (depending on state and beneficiary’s rate) on assets likely sold before death? Again, the wealthier the children, the less charitably inclined and the more unhealthy they are, the better it would be to limit the GPOA to GST exclusion available. The less the assets have special attributes (collectible, depreciable), the less likely to be sold and the less inherent gain, again, the better it would be to limit the GPOA to GST exclusion available. My personal observation is that most clients (and their children) would rather save $5 during their life than $10 at their death.

Don’t forget to consider some sort of expression of general settlor intent along with a trust amendment mechanism to adapt to future changes in tax law (there are paragraphs in the first sample clause), or when attorneys more clever than you or I come up with better ways to draft such clauses.

Note #2 – Because a powerholder can choose whether to appoint to a “skip person” or not, query whether you want to amend the GPOA so that appointive assets are limited to GST exclusion whether assets are or would be appointed to a skip person or not, for the same reasons discussed regarding clauses to ignore a powerholder’s charitable/marital deduction (see pages 35-39 in main article). For smaller estates, nothing would be lost, but for larger estates where the spouse has additional AEA due to DSUE, it could matter.
More Sample Language (Simplified versions)

**Formula General Power of Appointment** – Subject to the remaining provisions of this Section, my spouse has the testamentary power to appoint a certain portion of assets remaining in the Family Trust at my spouse’s death. My spouse may appoint the largest portion of the assets of this trust which would not increase any federal [or state] estate tax payable by my spouse’s estate [without taking into consideration any charitable or marital bequest by my spouse that would be deductible by her estate pursuant to IRC §2055 or §2056] to my spouse’s creditors or to my descendants in such amounts and subject to such terms, including trusts, as my spouse directs.

[note, this has no reference to IRD, insurance, loss assets, cash, etc – the bracketed language regarding state estate tax and whether to gross up with the charitable/marital deduction is discussed earlier in this paper. However, this is very simple, and apparently tracks the PLRs that used GPOA capping language – a slight variation is below.

**Formula Fractional General Power of Appointment.** Subject to the remaining provisions of this Section, my spouse has the testamentary power to appoint a certain fraction of the assets remaining in the Family Trust at my spouse’s death. My spouse may appoint the largest fraction of the assets of this trust which would not increase any federal [or state] estate tax payable by my spouse’s estate [without taking into consideration any charitable or marital bequest by my spouse that would be deductible by her estate pursuant to IRC §2055 or §2056] to my spouse’s creditors or to my descendants in such amounts and subject to such terms, including trusts, as my spouse directs. The assets subject to the general power of appointment shall be those assets which, within the fraction, have the greatest difference between the basis of the asset, and the fair market value of the asset, excluding any income in respect of a decedent.

**Basic Formula General Power of Appointment copied from PLR 2004-03094:**

At my wife’s death, if I am still living, I give to my wife a testamentary general power of appointment, exercisable alone and in all events to appoint part of the assets of the Trust Estate, having a value equal to (i) the amount of my wife's remaining applicable exclusion amount less (ii) the value of my wife’s taxable estate determined by excluding the amount of those assets subject to this power, free of trust to my deceased wife’s estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my wife may direct in her Will.
Additional Language to Cap a testamentary GPOA in the event a Power Holder’s Estate is Substantially Insolvent (to prevent appointive assets from potentially being diverted to a power holder’s estate’s creditors) – loosely based on PLR 9110054, discussed in Part III.m.

“Additional prerequisite for and restrictions on a power holder’s GPOA
In the event that the enforceable liabilities of the beneficiary power holder’s estate exceed the value of the assets against which the estate’s creditors could otherwise enforce against (based upon values as finally determined in the federal or state estate tax proceedings of the beneficiary’s estate, excluding the Power) by more than $5,000 [or pick another de minimis amount], no testamentary General Power of Appointment is granted herein unless the (i) the amount of tax basis that would be increased by reason of the beneficiary's death computed as if the property that would be appointable by this power if not for this paragraph had been included in the beneficiary's gross estate, (ii) times 20% (this could be less of course, or perhaps you use a higher number in a high tax state, or estate with depreciable property/collectibles) exceeds the excess of the enforceable liabilities of the beneficiary's estate over its assets, computed as if there were no General Power granted.

By way of example in explaining this paragraph, if the amount of tax basis that would otherwise be gained by the above mentioned testamentary formula GPOA without the above paragraph would be $600,000, and the power holder’s estate is insolvent with a deficit of $100,000, the formula power of appointment would still be granted, because $600,000 times 20% = $120,000, which exceeds $100,000.”

Note: taxable estate assets pulled in under 2035 or 2036 may not be subject to creditors under state law as GPOA appointive assets might, and life insurance may also be included in a taxable estate but have similar creditor protection, hence the reference above to assets to which a creditor might otherwise enforce against. Few estates of families with enough wealth to use trusts are completely and substantially insolvent and have aggressive creditors coming after their estate within the statute of limitations, and aggressive enough to go after non-probate assets that would be more difficult to reach in the best of circumstances. But, it can’t hurt to add this in my opinion.

Note to self: Also research whether, if someone has an LPOA and a GPOA, can they exercise the LPOA, or is that deemed to exercise the GPOA? What if we make potential appointees DIFFERENT BENEFICIARIES? That may avoid the problem of the inadvertently exercised GPOA.
Sample Language for Exercising LPOA for Bypass (Family) Trust in Order to Trigger the Delaware Tax Trap to Adjust Basis for Appreciated Assets

(to be included in Will or Living Trust, as directed by original document)

Pursuant to paragraph X of my spouse’s trust dated xx/xx/xxxx, I was granted a testamentary limited power to appoint the assets of said trust by specifically referring to that power in my (will, living trust or other deed). I hereby exercise that power as follows:

I hereby appoint the following assets to the:

1) [newly drafted Trust for a child or other intended beneficiary that grants the beneficiary a PEG Power – presently exercisable general power of appointment] or,

2) [the XYZ Appointive Trust], which shall be identical to the subtrust under Article III, Paragraph A of the XYZ Trust dated XX/XX/XXXX, which terms are incorporated herein, with the exception that this trust shall have the following additional paragraph applied: “During my child’s [beneficiary’s] lifetime, my child shall have a presently exercisable general power to appoint any or all assets of this trust to his or her creditors, to him or herself or to any of my descendants in such amounts or under such terms as my child [beneficiary] deems appropriate.”

COPY LANGUAGE FROM FORMULA GPOA ABOVE HERE (inclusive or exclusive definition)

2) I hereby appoint all remaining assets of the XXXX trust that were not appointed in Paragraph 1 to the [Surviving Spouse’s Trust that does NOT grant anyone a PEG Power, and the trust that would probably be allocated any GST exemption] [or simply don’t appoint the other assets at all and let them pass via residuary]
Sample Language for an LPOA in a Bypass (Family) Trust Designed to be Eligible to be Retained Even When Trust is Funded Via Qualified Disclaimer – Still Allowing the Surviving Spouse Dispositive Control in Order to Trigger the Delaware Tax Trap to Adjust Basis for Appreciated Assets

(see discussion in Part IV – remember, limited LIFETIME powers might trigger a gift tax if the powerholder has a mandatory income interest even if DTT is not triggered– if it is done in such a way as to trigger the DTT, it DOES trigger a taxable gift under IRC §2514, regardless of whether a spouse has mandatory income interest – but many spouses couldn’t care less – the income tax benefit of spraying income may far outweigh any gift tax ramifications)

During my spouse’s lifetime and upon my spouse’s death, my spouse shall have the power to appoint, from income or principal, in cash or in kind, all assets of this trust to a trust or trusts for any or all of my descendants that qualifies the transfer as a taxable gift or bequest under IRC §2514(e) or §2041(a)(3), such as a trust for my descendant that grants my descendant a presently exercisable general power of appointment or a trust that would otherwise trigger taxable gifts/bequests under applicable state law. All other appointees are excluded, specifically my spouse, my spouse’s estate, my spouse’s creditors, and creditors of my spouse’s estate, in addition to any other party not described above.

In addition, during my spouse’s lifetime, my spouse shall have the power to appoint, from income or principal, in cash or in kind, assets of this trust to any or all of my descendants, but limited to amounts necessary for their health, education or support. This paragraph should not be interpreted to grant my permitted appointees any property interest as a result of being a permitted appointee, and my spouse shall have no fiduciary duty whatsoever to them during my spouse’s lifetime under this paragraph. The above limitations shall serve as a ceiling to limit my spouse’s ability to direct the beneficial enjoyment of property pursuant to Treas. Reg. §25.2518(e)(2) and (e)(5) Example 6.

The above power of appointment is intended to be retained while still qualifying any transfers made to this trust pursuant to my spouse’s disclaimer, pursuant to IRC § 2518 and the exception for retained spousal rights to direct the beneficial enjoyment of property under Treas. Reg. §25.2518(e)(2). It shall be interpreted accordingly.
Sample Language for a Partial Release of a Broad LPOA in a Bypass (Family) Trust where the Surviving Spouse Desires to Fund Bypass via Qualified Disclaimer – Still Allowing the Surviving Spouse Dispositive Control in Order to Spray Income and/or Trigger the Delaware Tax Trap at Death to Increase Basis for Appreciated Assets

Example of when to use this: John and Jane have basic AB trusts, with broad LPOAs in the bypass trust. The trusts are mostly unfunded, then John dies. Jane proposes to disclaim her POD/TOD/JTWROS interests, in which case the assets will pour into the Bypass, but retention of a broad LPOA would taint the disclaimer (it would result in a taxable gift, loss of asset protection, full 2036 inclusion, full step down at second death). Jane could disclaim the entire LPOA, losing the tax flexibility to spray income and get a step up in basis at second death, or, for potentially better income tax results, she may execute a partial release as envisioned below. When she then disclaims, the retained LPOA, which can only be exercised in a way to trigger estate/gift tax, should meet the exception in the qualified disclaimer regs cited below.

Pursuant to paragraph X of my spouse’s trust dated xx/xx/xxxx, I was granted a limited [testamentary] power to appoint the assets of said trust by specifically referring to that power in my (will, living trust or other deed). I was granted the power to appoint to __________________________ [often this will be either to descendants or to anyone but the powerholder, powerholder’s estate or creditors of either], which includes the power to appoint to a trust therefore [usually trusts include this power – if yours does not, check state law (common law under Restatement is favorable), which probably includes it anyway].

[to use if a lifetime power is granted in the original trust] As to my limited power to appoint during my lifetime, I hereby partially release and disclaim the above mentioned power except that I shall retain only 1) the power to appoint to a trust for the permitted appointees that will trigger a federal gift tax under IRC §2514(e) upon transfer and 2) the power to appoint to any of the permitted appointees directly, but limited to amounts necessary for their health, education or support. I hereby release and disclaim the power to appoint during my lifetime beyond the appointees or amounts described above.

[more common – to use if a testamentary power is granted in the original trust] As to my limited testamentary power to appoint upon my death, I hereby partially release and disclaim the above mentioned power except that I shall retain only the power to appoint to a trust for any or all of the permitted appointees that will trigger a federal estate tax under IRC §2041(a)(3) upon transfer. I hereby release and disclaim the power to appoint to any other appointee.

This release/disclaimer is intended to qualify any future or contemporaneously executed disclaimer that would cause a transfer to the trust referenced above, such that the rights retained after release/disclaimer comply with the requirements of IRC §2518 and the exception for retained spousal rights to direct the beneficial enjoyment of property under Treas. Reg. §25.2518(e)(2) and (e)(5) examples 6 and 7. It shall be interpreted accordingly and shall be given effect regardless of whether this release/disclaimer of interests is itself a qualified disclaimer under IRC §2518.
Note – There is no example in the §2518 Regs of whether such a disclaimer is “qualified” (is it “severable”?) , which is why I referred to the above as a “release” and/or “disclaimer”, not a “qualified disclaimer”. See §25.2518-3(A)(iii) and examples 9 and 21 in that Reg for disclaiming POAs, which are considered as separate property interests for disclaimer purposes. Whether the above would be “qualified” is irrelevant, at least for the limited purpose of this Release, which is to prepare another disclaimer to be qualified – a release may accomplish the same thing as a qualified disclaimer in some cases without ill effect. For a great example of a clever use of a partial release of a GPOA to qualify a trust as a “see through trust”, see PLR 2012-03033. If a GPOA is released (not a qualified disclaimer), it would be a gift taxable event based on the underlying assets (see IRC §2514(b)) (although it may be delayed by being an incomplete gift if powers are retained as contemplated by a partial release), but a release of an LPOA, or portions of an LPOA, would not be – see Treas. Reg. §25.2514-3(e) example 3 “If in this example L had a power to cause the corpus to be distributed only to X, L would have a power of appointment which is not a general power of appointment, the exercise or release of which would not constitute a transfer of property for purposes of the gift tax.”
Sample Lifetime Limited Power to Appoint to Enable Surviving Spouse to Spray Income to Children and/or Charities

(including provisions limiting such powers for see-through trust status for retirement benefits and qualified subchapter S trusts – obviously this is not for marital trusts, practitioners in states with separate state estate/inheritance taxes should investigate to what extent such powers might affect trusts intended to qualify for that state’s separate estate/inheritance tax marital deduction – practitioners in those states may divide a bypass/credit shelter trust between a “B1” share that is state estate exempt and a “B2” share that is eligible for separate state QTIP – if necessary, a lifetime limited power of appointment might be limited to only the “B1” share if that would save state estate taxes)

The trustee shall distribute all or any portion of the trust estate, from income or principal, as my spouse may appoint during my spouse’s lifetime, to any of my descendants, in trust or outright. [Any appointment that is not equal to my children or their issue per stirpes may only be made with permission of ______, or the unanimous permission of my children, or their representative issue per stirpes. – Some may fear a surviving spouse might be unduly influenced by one child to make unequal distributions thwarting an intended equal estate plan. Some may not care if their surviving spouse does this, and there may be very good reasons to make unequal distributions. In my experience, more than half would opt to allow their spouse more flexibility and trust their spouse’s judgment and sense of fairness. Because a lifetime LPOA is not intended to trigger gift/estate tax, we really don’t care for tax reasons whether a non-adverse or adverse party consent is required.]

This limited power of appointment shall not be exercisable, directly or indirectly, to discharge any legal obligation of the powerholder.

In addition, the trustee shall distribute all or any portion of the trust estate as my spouse may appoint during my spouse’s lifetime, whether such income is allocated to accounting income or principal, to any one or more organizations each of which is, at the time contemplated for an actual distribution to such organization, exempt from federal income taxation under § 501(a) as an organization described in § 501(c)(3). These appointive assets shall be limited further as follows:

5) only from gross taxable income as contemplated under IRC §642(c) [as discussed herein, this might also be further limited to higher tax rate income, but many clients would want the broader ability to spray even “lower rate” LTCG/QD income], and

6) only from gross income that would not otherwise be unrelated business income pursuant to Treas. Reg. §1.642(c)-3(d), IRC §681(a) and regulations thereunder (such as taxable income from an ongoing closely held business)

It is my intention under this provision that any such appointments qualify for an income tax deduction pursuant to IRC §642(c), as amended, and this provision shall be construed and may be amended accordingly.
NOTE: If the trust is intended to be a “see through trust” holding qualified plan/IRA benefits, you will want to modify lifetime powers accordingly, depending on whether the trust is a conduit or accumulation trust. As noted elsewhere herein and in other articles and CLE outlines, it is probably better, especially when using more flexible tax provisions such as the above, to have such benefits in a separate trust altogether because it is unclear whether you can adequately trace or convince the IRS that you are adequately tracing and limiting any accumulations from those retirement benefits. Remember that a trust may qualify as a conduit for a spouse even if other younger beneficiaries might be entitled to distributions (be a “see through trust” with the spouse’s life expectancy as measuring life/“designated beneficiary”), but if younger beneficiaries might take via LPOA, the spouse would not be “sole beneficiary” and therefore would lose the other two major benefits – a potentially delayed required beginning date and recalculation of life expectancy every year. However, if you have an accumulation trust, you might lose those two advantages, but you can retain a spray power, as long as the potential appointees are all younger individuals, which would allow shifting high bracket ordinary income.

[For a conduit trust intended to achieve “sole beneficiary” status – Notwithstanding the above paragraphs, my spouse’s lifetime limited powers to appoint shall not apply to any deferrable retirement benefits [you might want to have/refer to a definition for this], and such assets shall not be considered appointive assets subject to this power, nor shall this lifetime power to appoint apply to any benefits temporarily received as a distribution from a retirement plan that must be thereafter distributed to my spouse. It is my intention that this lifetime limited power of appointment be subordinate to the conduit trust provision in paragraph ____.

[For conduit trust where “sole beneficiary” status not sought, or accumulation trust - Notwithstanding the above paragraphs, my spouse’s lifetime limited powers to appoint shall not be further limited as to any deferrable retirement benefits [you might want to have/refer to a definition for this]. My spouse may only appoint retirement benefits during my spouse’s lifetime to my descendants outright. This may include qualifying trusts for my descendants only if a copy of the trust is given to the IRA custodian/trustee by October 31 of the year after my death and said trust would otherwise qualify as a see through trust/designated beneficiary itself.]

Notwithstanding the above paragraphs, my spouse may not exercise any lifetime limited power of appointment over any S Corporation stock or distributions therefrom, over which a qualified subchapter S corporation (QSST) election has been made, nor from any trust portion over which a marital deduction was or will be elected as qualified terminal interest property under federal estate tax or its applicable state estate tax law equivalent.
Note – if there is testamentary formula GPOA, the spouse may be triggering a taxable gift by exercising a lifetime limited power of appointment. So a lifetime power works optimally for gifts beyond the annual exclusion amounts if the “optimal basis increase” clause is a lifetime testamentary limited power of appointment intended to trigger the Delaware Tax Trap under §2041(a)(3) to increase basis. However, any formula testamentary GPOA will exclude certain assets, such as retirement plan/IRD. Could we fashion a lifetime power to only come from those excluded assets to avoid §2514? Probably, but it is unclear how that would play out, especially for assets such as cash that might be excluded from a formula TGPOA one day, and included the next. For many middle income taxpayers with plenty of estate/gift tax exclusion, this would not be an issue, and income tax savings goals would trump saving any superfluous estate/gift tax exclusion. However, we would want to warn clients of the possibility of its application – and for some clients, it may matter. Similarly, if the spouse had a §678(a) power or is otherwise entitled to mandatory income, using a lifetime limited power of appointment could also trigger a gift tax or possibly even trigger an assignment of income even if there is no testamentary GPOA. See the Regester and Self cases discussed in footnote 280.

SEE NEXT SAMPLE CLAUSE ON ANOTHER WAY TO GET AROUND THIS.
Sample Trustee Spray Power and/or Lifetime Limited Power to Appoint to Enable a Party Other than Current Beneficiary (spouse) to Spray Income to Children and/or Charities

As discussed in the notes to the previous sample lifetime LPOA clause, there are some drawbacks to the surviving spouse being granted a lifetime POA – in some cases it may trigger a taxable gift or an assignment of income. Of course, giving an independent trustee spray powers is one way to get around these rules. However, in my experience, settlors do not want to give independent trustees such broad spray powers at the expense of the surviving spouse, trustees don’t necessarily want it because of the increased administration, due diligence and liability, and there may be additional reporting, accounting and notice requirements as well – trustees would have fiduciary duties to the beneficiaries under a traditional spray provision (which can also be viewed as a fiduciary lifetime limited power of appointment). One way to alleviate some, but not all, of those concerns would be to grant a spouse a veto power regarding any such distributions by the trustee. The other way, to me, preferred, is to grant a non-fiduciary lifetime limited power to appoint to someone other than the surviving spouse (this is known as a collateral power) – this prevents many more of the issues noted above.

The trustee shall distribute all or any portion of the trust estate, from income or principal, as ______________ (someone other than the spouse) may appoint during my spouse’s lifetime, to any of my descendants, in trust or outright. In addition, the trustee shall distribute any portion of the trust estate, but only from gross taxable income, as __________ may appoint during my spouse’s lifetime, whether such gross taxable income is allocated to accounting income or principal, to any one or more organizations each of which is, at the time contemplated for an actual distribution to such organization, exempt from federal income taxation under § 501(a) as an organization described in § 501(c)(3).

Any appointment may only be made with permission of [my spouse, or my spouse’s agent, conservator or guardian][unanimous consent of my spouse’s children].

Any lifetime power of appointment should constrain see through trusts/QSSTs as noted in prior sample language.

Would a spousal consent to someone else’s appointment somehow a negative ramification? This is unlikely, but possible, depending on the issue, thus the bracketed examples of granting a spouse a veto power versus other parties who would indirectly act on behalf of a spouse. While the former is probably sufficient, the latter would be safer in all events.
Draft Provision to Enable and Order Distributions of Capital Gains to be Carried Out to Beneficiaries

Trust Accounting for Discretionary Distributions to Beneficiaries

"To the extent that discretionary distributions are made from capital gains allocated to 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 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 remaining net short term capital gains not described in the above paragraph;
3) from any 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);
4) lastly, from any remaining current year long-term capital gains not described in the above paragraph.

This paragraph is intended to ensure compliance with Treas. Reg. §1.643(a)-3(b)(2)"
Draft of Proposed Opt-In Rule Against Perpetuities Amendment for Adoption in States to Provide Improved Tax, Estate and Asset Protection Planning Options for their Citizens

(portions plagiarized from 25 Del. Code §§ 501, 504, with an opt in feature added)

Ohio Rev. Code proposed §2131.08(H):
Notwithstanding any other provision of this chapter, in the case of a nongeneral power of appointment over property held in trust (the "first power"), and only wherein the instrument exercising the power either

a. specifically refers to this paragraph, or
b. specifically asserts an intention to trigger Section 2041(a)(3) or Section 2514(e) of the Internal Revenue Code of 1986, or
c. specifically asserts an intention to postpone the vesting of any estate or interest in the property which was subject to the first power, 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

then, and only to the extent intended and specified in the instrument, any estate or interest in property, real or personal, created through the exercise, by will, deed or other instrument, of the first power, irrespective of the manner in which the first power was created or may be exercised, or whether the first power was created before or after the passage of this section [alternatively, “but only if the date of creation of that nongeneral power of appointment is on or after the effective date of this section], shall, for the purpose of any rule of law against perpetuities, remoteness in vesting, restraint upon the power of alienation or accumulations now in effect or hereafter enacted be deemed to have been created at the time of the exercise and not at the time of the creation of such power of appointment.

[Ohio defines non-general power in another statute, otherwise you might add something like “and the first power may not be exercised in favor of the donee, the donee's creditors, the donee's estate or the creditors of the donee's estate”]

Also – You might add “testamentary”, or limit to 2041(a)(3), since there would not be much use in triggering a taxable gift under 2514(e). However, might you have a case of a GST non-exempt trust where someone wants to appoint and use their gift/GST exemption? Perhaps someone more creative than I can find a use, but I can’t see much harm in including the gift possibility as long as the appointment has to affirmatively opt-in.

I don’t think the bracketed language above is necessary, since I don’t think an opt-in statute has the danger of inadvertently causing some calamity based on application to existing LPOAs, but I’m still thinking this over a bit. Comments welcome.
Decanting and Trust Agreement

This declaration of **decanting and trust agreement** is executed in the State of __________, on the date hereafter set forth, by ________________________, as Trustee.

**Whereas:**

1. The Settlor, ____________________________, created an irrevocable trust [revocable trust made irrevocable by the settlor’s death on XX/XX/XXXX], the ___________________________trust (“First Trust”), attached hereto.

2. ___________________________ is now acting as sole trustee of the First Trust, which is now in existence. [or amend for co-trustees accordingly]

3. Pursuant to Article XX, Paragraph YY, the First Trust provides that the Trustee may in its discretion make distributions to Settlor’s spouse, ____________________________, for her “[insert terms from trust that indicate broad trustee discretion to distribute].” (if you don’t have broad discretion, but HEMS, then go to plan B, see subsequent sample).

   a. Ohio R.C. §5808.18(A) provides in pertinent part, that “If a trustee of a trust, *** has absolute power*** to make distributions of principal to one or more current beneficiaries, that trustee may exercise that power by 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 another trust, ***that is for the benefit of one or more current beneficiaries of the first trust*** If property is distributed pursuant to the authority described in division (A) of this section, the governing instrument may do***the following: (a) Grant a power of appointment to one or more of the beneficiaries for whose benefit the property was so distributed, including a power to appoint trust property to the power holder, the power holder’s creditors, the power holder’s estate, the creditors of the power holder’s estate,” [note: most state decanting laws allow granting an LPOA/GPOA if the trustee has broad discretion. Consult this list of decanting statutes with analysis of each state’s power to add POAs at [http://www.sidley.com/state-decanting-statutes/](http://www.sidley.com/state-decanting-statutes/) and insert your applicable state statute or case law citation in lieu of the Ohio statute above. If your state has no decanting power, you may be able to change situs to one that does using a nonjudicial settlement agreement or other trust power.]

   b. [Use if state law requires notice to beneficiary, but frankly even if prior notice is not required pursuant to statute it’s probably a good idea or may even be required under other fiduciary duties.] Pursuant to Ohio R.C. §5808.18(F), all current beneficiaries are entitled to at least 30 days written notice of this distribution unless all current beneficiaries waive this. Evidence of this notice and/or waiver is attached herein.

**Now Therefore:**
The undersigned Trustee hereby directs that all [or, alternatively, a trustee might only decant those assets capable or desiring of a step up in basis] of the Trust assets of the First Trust shall be distributed to __________________________, as Trustee of the Second Trust (as defined herein), to be administered as a part thereof.

“Second Trust” means the trust created under this instrument. The terms of the Second Trust shall be the same as the terms of the First Trust, which terms are incorporated herein by reference, except for the additional provisions as set forth below:

1. Trustee hereby grants to __________________________ [settlor’s spouse or other beneficiary] a testamentary general power of appointment [limited power of appointment] as follows:

INSERT PARAGRAPHS GRANTING GPOA or LPOA TO TRIGGER §2041(a)(3) HERE

Consider – if the state decanting statute does not allow for removal of a GPOA/LPOA (many decanting statutes are silent on this issue and only specifically permit ADDING one rather than removing one), then you might add an expiration period (aka “Boomerang clause”), which lets the trust lapse back to its original state and would force the trustee to keep on top of the issue and periodically renew the decanting (or better, a default might be to lapse only upon trustee’s affirmative action). Another solution would be to add as part of the decanting a trust protector/amendment provision that would allow the subsequent removal, addition or amendment of the POA (this would be my preference). Why? What if Congress amended §1014/§2041 someday or the powerholder incurs significant debt? Along those lines, see the statement of settlor intent embedded in some of the sample clauses to permit the POA to be amended to conform with that intent.

IN WITNESS WHEREOF, __________________________ [through its duly authorized representative], hereby signs this instrument in its (his/her) capacity as both Trustee of the First Trust and as the Trustee of the Second Trust, on the date hereinafter set forth.

__________________________, Trustee

By: __________________________

Date: __________________________

STATE OF OHIO )
 ) SS.
COUNTY OF WARREN )
The foregoing instrument was acknowledged before me by
________________________ [on behalf of __________________________], Trustee
on __________________, 2014.

(SEAL)

________________________
Notary Public

This Instrument was Prepared By:
________________________
Notice Letter to Current Trust Beneficiary regarding Decanting

Date

Re: XYZ Trust dated XX/XX/XXXX

Dear _________ ,

As we have previously discussed, this letter is to give you formal notice of our intention to distribute all [or, as discussed above, only certain assets] of the assets of the above trust to a new trust. The terms of the new trust will be identical to the terms of the old trust except that the new trust will grant you a general power to appoint the assets in the trust at your death to the creditors of your estate [alternately, the decanting might only grant a limited power]. The proposed amendment and distribution, called a “decanting” is attached to this notice.

You have given us an approximate net worth statement attesting to your solvency and have told us that you are not co-signed on any loans or know of any outstanding debts or potential claims against you other then those on the net worth statement. The reason we asked you questions regarding this was to protect the trust and beneficiaries from any potential future creditors of your estate. The purpose of adding this clause is to ultimately benefit your children and/or grandchildren who will be entitled to receive the assets of the trust upon your death.

Under the current trust, the assets of this trust would not included in your taxable estate, and they would not receive a step up in basis at your death. The approximate amount of this appreciation as of the last end of quarter was $800,000 [insert approximate value].

This newly added general power of appointment should cause the assets of this trust to be included in your estate for federal estate tax purposes at your death, but only to the extent it does not cause an estate tax liability to occur. More importantly, this should cause any appreciated trust assets held in the trust to receive a step up in basis for income tax purposes.

This may ultimately save the children and/or grandchildren approximately 15-30% income tax on this appreciation, potentially saving them hundreds of thousands of dollars, depending on where they reside, the nature of the gain and asset appreciation at the time, when they sell the assets and other factors.

This amendment will be effective 30 days from this letter. However, you may not want to delay the amendment this long. Should you prefer to make it effective immediately, you may waive the 30 day notice requirement by emailing or sending us a short note such as “I hereby waive the 30 day notice requirement mentioned in your letter and proposed agreement dated _______”.

Sincerely,

Trustee
Decanting and Trust Agreement
(where trust pays all net income or has HEMS type ascertainable standards – §5808.18 “paragraph B” decanting)

This declaration of decanting and trust agreement is executed in the State of ___________, on the date hereafter set forth, by ____________________________, as Trustee.

Whereas:

1. The Settlor, _______________________________, created an irrevocable trust [revocable trust made irrevocable by the settlor’s death on XX/XX/XXXX], the ___________________________trust (“First Trust”), attached hereto.

2. ______________________________ is now acting as sole trustee of the First Trust, which is now in existence. [or amend for co-trustees accordingly]

3. Pursuant to Article XX, Paragraph YY, the First Trust provides that the Trustee shall pay all net income at least annually, plus in its discretion may pay additional sums of principal, up to the entire trust, to Settlor’s spouse, _______________________________, for her “health, education, maintenance and support [insert terms from trust].”

4. Ohio R.C. §5808.18(B) provides in pertinent part, that “Unless the trust instrument expressly provides otherwise and subject to the limitations set forth in this section, a trustee of a first trust who has power, other than absolute power as described in division (A) of this section, under the terms of the first trust to make distributions of principal to one or more current beneficiaries may exercise that power by 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.” The trustee hereby states that as of this decanting, all currently distributable net income has been paid. Ohio R.C. §5808.18(B) further provides “The second trust may be a trust ***** created by the trustee of the first trust. The power described in this division may be exercised whether or not there is a current need to distribute trust principal under any standard contained in the first trust. 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.” [note: see points regarding decanting statutes in general in previous sample].

5. Due to the limited nature and limited changes below, this decanting will not affect the beneficiary’s entitlement to income nor the trustee’s distribution standards, nor materially change the interests of the beneficiaries of the first trust.

6. [Use if state law requires notice to beneficiary, but frankly even if prior notice is not required pursuant to statute it’s probably a good idea or may even be required under other fiduciary duties.] Pursuant to Ohio R.C. §5808.18(F), all current beneficiaries are entitled to at least 30 days written notice of this distribution unless all current beneficiaries waive this. Evidence of this notice and/or waiver is attached herein.
Now Therefore:

The undersigned Trustee hereby directs that all [or, alternatively, a trustee might only decant those assets capable or desiring of a step up in basis] of the Trust assets of the First Trust shall be distributed to _________________________________, as Trustee of the Second Trust (as defined herein), to be administered as a part thereof.

“Second Trust” means the trust created under this instrument. The terms of the Second Trust shall be the same as the terms of the First Trust, which terms are incorporated herein by reference, except for the additional provisions as set forth below:

1. Trustee hereby grants to _____________________ [settlor’s spouse or other beneficiary] a testamentary general power of appointment [limited power of appointment] as follows:

   INSERT PARAGRAPHS GRANTING NARROW TESTAMENTARY GPOA or LPOA TO TRIGGER §2041(a)(3) HERE

   Some may argue that adding a narrow testamentary power of appointment would “materially change the interests of the beneficiaries of the first trust”, principally of course the remaindermen. For certain, it would make their vested interests subject to divestment, or at least some form of divestment – if, for example, the trustee added an LPOA that only allowed appointment to trusts for children in equal per stirpes shares, granting them a PEG power, as opposed to the residuary of the trust which simply distributes to the children outright, is this really a “material change” for purposes of Ohio’s decanting statute? I doubt any beneficiary or Ohio court would see that as material, but it’s still enough to trigger the Delaware Tax Trap and may save the family hundreds of thousands of dollars in income tax.

   IN WITNESS WHEREOF, ________________________________ [through its duly authorized representative], hereby signs this instrument in its (his/her) capacity as both Trustee of the First Trust and as the Trustee of the Second Trust, on the date hereinafter set forth.

   ________________________________, Trustee

   By: ________________________________

   Date: ________________________________

STATE OF OHIO )
   ) SS.
COUNTY OF WARREN )
The foregoing instrument was acknowledged before me by
________________________ [on behalf of ____________________________], Trustee
on ____________________, 2014.

(SEAL)  
Notary Public

This Instrument was Prepared By:

___________________________

___________________________

If you are in Ohio or a state like Ohio, attach notice or waivers of notice.
Examining Irrevocable Trusts for Opportunities to Step Up Basis at Death of Beneficiary

1) Does the trust grant the beneficiary a *general* power of appointment, allowing the beneficiary to appoint to himself, his estate or creditors or either? Or, does the trust direct the trustee to pay debts/creditors of the decedent/beneficiary? If yes, then **stop** – the assets in the trust will receive a date of death basis. ³²⁸

2) Does the trust name the beneficiary as controlling trustee, or allow the beneficiary to name themselves as controlling trustee, without any ascertainable standards as to distribution to that beneficiary? And, is the trust situated in a state that does not have a savings statute to graft ascertainable standards upon the trust? If yes, then **stop** – the assets in the trust will receive a new basis on the beneficiary’s death. These would be very rare, and trusts or states often have a savings clause preventing this result.

3) Could the trust have otherwise initially qualified for a QTIP election (all income to spouse, no other beneficiary, etc) and no Form 706 was filed? Consider filing Form 706 with a late QTIP election, so that trust gets a second step up in basis when the surviving spouse dies.

4) Does the trust have a trust protector/advisor or other clause permitting a trust protector, trustee or other non-adverse party the ability to add a GPOA or LPOA? If the powerholder is still alive, add it but release/disclaim any power to add a GPOA over cash, loss assets, IRD, etc, or assets exceeding a powerholder’s available AEA. If not, and it was not added, argue that such a power in itself is a GPOA held by spouse merely requiring the consent of a non-adverse party, hence a GPOA per §2041(b)(1)(C)(ii)

5) Does the trust grant the beneficiary a *limited* testamentary power of appointment? The clause does not have to use those words precisely; it must merely allow the beneficiary to direct where assets go at their death. If yes, then does the trust permit the beneficiary powerholder to appoint to a trust or “for the benefit of” individual beneficiaries? Most state laws will allow appointment to trust if the trust/power is silent. See Restatement of Property, Third, Donative Transfers, §19.13 and §19.14. If yes, then go to step 6. If no, go to step 7.

6) Has the powerholder appointed to a trust or subtrust for intended permissible beneficiaries, granting one or more of them a presently exercisable general power of appointment (withdrawal right, such as a Crummey power, or power of revocation), even if it’s only a present power of the remainder of the trust coupled with an income interest? If yes, then any assets so appointed will receive a new date of death basis. If the appointive

³²⁸ This might occur in a GST non-exempt trust, for example. Certain categories of assets do not receive a new basis, such as annuities and retirement plans (income in respect of a decedent). Occasionally, the decedent’s executor or trustee may elect an alternate valuation date which would use a date of subsequent sale within 6 months after death or 6 months after date of death. Because assets declining in value would receive a step down in basis, consider distributing or selling assets with substantial valuation declines prior to death if possible if a GPOA cannot be avoided.
trust has only a partial power, such as a withdrawal right limited to a 5/5 power, then this is likely pro-rated to only cause inclusion of 5% of the trust. If no, then do so.

7) Does the trustee have wide discretionary power to distribute corpus to the beneficiary and is governed by a state law that permits decanting? If yes, then the trustee may decant to add a GPOA/LPOA to enable a new basis at the death of the powerholder.329

8) Is the trust governed by the UTC or other state law that would allow a trustee or beneficiary to petition the court for an amendment to add a GPOA/LPOA? If yes, then the trustee may petition the court (or a beneficiary might, but see Part VII of article cautioning against the potential adverse effect of beneficiary actions) to amend the trust to add a narrowly crafted GPOA/LPOA to enable a new basis on the death of the powerholder.

329 See list of decanting statutes with analysis of this power at http://www.sidley.com/state-decanting-statutes/
Forfeiture provision to add to spendthrift clause for better asset protection, with an appropriate carve out for marital deduction trusts, QSST, IRA, 678(a)

If by reason of any act of any such beneficiary, or by operation of law, or by the happening of any event, or for any other reason except an act of the Trustee authorized hereunder, any of such income or principal shall, or except for this provision would, cease to be enjoyed by such beneficiary, or if, by reason of an attempt of any such beneficiary to alienate, charge or encumber the same, or by reason of the bankruptcy or insolvency of such beneficiary, or because of any attachment, garnishment or other proceeding, or any order, finding or judgment of court either in law or in equity, the same, except for this provision, would vest in or be enjoyed by some other person, firm or corporation otherwise than as provided herein, then any mandatory trust distribution provisions (including a terminating distribution, unless required by the applicable rule against perpetuities) or withdrawal rights herein expressed concerning such income and/or principal shall cease and such beneficiary may only receive distributions at the sole and absolute discretion of the trustee. In such event, the trustee may, in its sole discretion, make distributions to any descendants of the beneficiary, and if there are no descendants of the beneficiary, to any of my descendants.

In addition to the above events triggering a forfeiture and voiding of a beneficiary’s mandatory interests and/or withdrawal rights, any filing in a court of domestic relations against a beneficiary or by a beneficiary, other than a petition for adoption or name change, such as for a divorce, dissolution or restraining order, shall expressly have the same effect as above.

Also – if you have trustee/beneficiary, “interested trustee” clauses, they might be integrated with this section to remove HEMS standards and require independent trustee to be appointed.

The death of a beneficiary shall also constitute a complete termination of such beneficiary’s interest in the trust and the trust estate and any payments accrued or undistributed by the trustee at the time of death of such beneficiary shall be distributed to the succeeding living beneficiaries or charities otherwise entitled to distributions from the trust estate. This paragraph shall not override any exercise of a testamentary power of appointment.

The above provisions shall not apply to remove a mandatory income interest from any trust share previously or currently qualified as a marital deduction trust or qualified subchapter S trust, or otherwise intended to qualify for the marital deduction or as a qualified subchapter S trust. The trustee’s filing of an ESBT election shall conclusively be presumed to indicate an intent not to qualify as a QSST and hence the above forfeiture provisions shall apply to any trust over which an ESBT election has been made. The trustee/executor’s failure to file Form 706/709 QTIP election for a trust that might otherwise qualify by the extended due date of the return shall conclusively be presumed to indicate an intent not to qualify for the marital deduction.

In addition, the above provisions shall not apply to remove a beneficiary’s current sole power to withdrawal income pursuant to Paragraph XXX, which grants the power to withdrawal accumulated income during a window from December 15-December 31. In such case, the above provisions shall only apply prospectively to remove any future years’ withdrawal rights, or, if the above triggers occur Jan 1-Dec 15, shall apply prospectively to remove the current year’s withdrawal right. The above provisions shall expressly apply to powers of revocation, withdrawal or any presently exercisable general power of appointment. [Note – see the Castellano case as to why this is included]

NOTE: I have seen several spendthrift clauses state that the entire clause does not apply to a marital trust or QSST or conduit trust. DON’T DO THAT. Treas Regs specifically authorize a basic spendthrift clause preventing assignment, alienation, etc, just not one that goes further to cause an actual forfeiture of the mandatory income interest.
Alternative disposition to save exclusion if DSEU/706 filing is botched
(see Part II, page 10, footnote 22)

Drafting Example: “I leave my entire residuary outright to my surviving spouse, on the precondition that my personal representative (or my trustee if no personal representative is appointed, pursuant to IRC § 2203) makes an effective election on an estate tax return pursuant to IRC §2010(c) to grant my spouse the use of my Deceased Spousal Unused Exclusion Amount. Should for any reason (intentional or unintentional), such an election is not effectively made, or is made for less than maximum amount available, I hereby leave the maximum amount possible without incurring a federal estate tax to the Bypass Trust described in Paragraph __, and any remaining residuary above this amount shall pass to my surviving spouse outright”. [I hereby indemnify my executor from any such election or failure to elect (be it partial, to the maximum extent or not made at all) made in good faith.] [NB: fractional formula variations on this, or a pecuniary marital, residual bypass would be desirable if IRD such as large deferred compensation plans might be involved].
Formula GPOA for GST non-exempt trust to optimize between GST and Estate Tax Efficiency

Contingent Testamentary General Power of Appointment. If upon the death of a beneficiary of this trust a taxable termination would occur (either directly, or indirectly by the beneficiary's failure to exercise a power of appointment), then the beneficiary shall have the testamentary general power to appoint to the creditors of the beneficiary's estate the smallest fractional share of the trust property that would reduce to a minimum the aggregate state and federal estate, inheritance and generation skipping taxes payable upon the beneficiary's death. Such fractional share shall be determined as if any power of appointment granted to the beneficiary (under this provision or otherwise) is not exercised and such taxable termination had occurred.

This particular clause is very basic and has no ordering rule and no preference for assets over which a GPOA would increase basis (e.g. excluding cash, IRD, loss assets etc). Again, like the very basic formula GPOAs over GST non-exempt trusts, it probably works just as well in many cases where a cap is not needed and it is likely to be 0% or 100%, and involve no loss assets. However, why risk this? See following for a more nuanced approach incorporating both these ideas.
Spousal waiver for INGs to prevent argument there is a grantor trust based on spousal interest, to prevent Kloiber/Dahl arguments upon divorce, or to help ensure completed gift for DAPTs or other irrevocable trusts not naming spouse where completed gift desired

WAIVER OF CERTAIN RIGHTS

I, the undersigned spouse of settlor, waive all of my rights, title, and interest in any property transferred to the attached ________ trust dated XX/XX/XXXX (the “trust”), other than as specified therein. This waiver shall apply both to current and inchoate interests that I may have, including, but not limited to, rights to an intestate share, statutory elective share, omitted spouse's share, or share in the nature of dower or curtesy, in the estate or augmented estate of settlor.

This waiver shall also apply to any rights to contest the transfer as a breach of trust or fiduciary duty or under any applicable Uniform Fraudulent Transfers Act, Uniform Fraudulent Conveyance Act or Uniform Voidable Transaction Act including common law remedies such as but not limited to equitable or constructive trusts.

This waiver shall not preclude voluntary appointments or gifts by any powerholder or beneficiary that might later directly or indirectly benefit me through their own independent actions. Nor shall this waiver preclude me from later disclaiming or releasing any such rights.

This waiver shall constitute a third-party beneficiary contract for the benefit of all the beneficiaries of the trust, and these beneficiaries or the trustee of the trust may enforce this waiver by appropriate legal action.

Dated: January 9, 2015

[Signatures and notary clause]

[Note: Each state may have its own requirements for validity of post-nuptial agreements. Would a simple waiver need to fulfill all the requisites under state law for post-nuptial agreements? Perhaps. This would not be the same as ERISA/REA spousal waivers which would be preempted by federal law. Is consideration required? Whether property contributed is separate or marital would probably matter. Spouses generally owe fiduciary duties to each other, beyond the scope of this outline. Any attorney representing both spouses skates on thin ice ethically trying to pull shenanigans like the Dahl and Kloiber cases illustrate (perhaps even those representing only one spouse if it is marital property). But in many instances a waiver like the above may be desired purely for tax and asset protection reasons - not asset protection from the spouse, but against third party creditors. Like any post-nuptial agreement, there are many situations and even techniques and other planning that can be done to ensure such waivers are not in any way abusive to spouses.]
Provision in will (or, potentially, revocable living trust, but usually in will) to exercise a power of appointment

Property Subject to Certain Powers of Appointment

I am granted a power of appointment (“First Power”) under paragraph _____ of the ______________ Trust dated XX/XX/XXXX. I am granted a power of appointment (“Second Power”) under paragraph _____ of the ______________ Trust dated XX/XX/XXXX.

[if the power is a general power, or limited power designed to trigger the Delaware Tax Trap, and if the power is not capped, such that exercise or even mere existence of the power may cause an state or federal estate tax, query whether you would want to equitably apportion such taxes, or perhaps apportion such taxes to the residuary or other assets]

(1) I exercise the First Power by directing that, all of the trust estate subject to the First Power shall be distributed to the Trustee of the James Jones Trust dated XX/XX/XXXX;

(2) I exercise the Second Power by directing that, upon my death all of the trust estate subject to the Second Power shall be distributed to the Trustee of the James Jones Trust dated XX/XX/XXXX, subtrust fbo charity pursuant to Article V; and

Here is an example of a Delaware Tax Trap savings clause, which may not be needed in some states/circumstances, and of course may not be desired in others where you are actively trying to trigger §2041(a)(3):

[Notwithstanding anything to the contrary, if my exercise of any of the above powers of appointment (“exercised power”) creates another power of appointment(s) (“new power(s)”); the new power(s) shall not be exercisable and may not postpone the vesting of any estate or interest in, or suspend the absolute ownership or power of alienation of, any property appointed pursuant to the exercised power (or any successor proceeds of such property), beyond the rule against perpetuities applicable to the exercised power.]
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):

- **LLC with $1 million property**
  - Husband and wife own 50/50
  - Basis is now $400,000 each.

- **Husband dies, 50% goes to 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.**

- **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**.
**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.
<table>
<thead>
<tr>
<th>Factors to Consider</th>
<th>Transfer Gain Property to ill spouse</th>
<th>Alaska/Tenn. CP Trust (Blattmachr, Zaritsky)</th>
<th>Lifetime GPOA Trust (Blase)</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>Transfer Gain Property to ill spouse</td>
<td>yes</td>
<td>no</td>
<td>no</td>
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<tr>
<td>1 Need independent/corporate trustee in TN/Alaska</td>
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<td>yes</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Settlor and/or settlor's spouse can be only trustees</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
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<tr>
<td>3 Is irrevocable (for CP transfer, spouses can revoke half)</td>
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<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
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<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>
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<td>5 Spouse can take some of transferred assets while living</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>6 Disinheritance risk if first to die has &quot;2nd thoughts&quot;</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>no*</td>
<td>yes</td>
<td>no*</td>
</tr>
<tr>
<td>7 Potential substantial loss if spouses divorce after transfer (for CP Trust, to extent transferred property unequal)</td>
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<td>yes</td>
<td>no</td>
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<td>Outside Creditor Protection Issues During Life</td>
<td>Increased creditor exposure if lifetime creditors arise (including destruction of tenancy by the entireties)</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
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<tr>
<td>8 Increased creditor protection if lifetime creditors arise</td>
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<td>yes</td>
<td>yes</td>
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<tr>
<td>9 Increased creditor protection if lifetime creditors arise</td>
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<td>no</td>
<td>no</td>
<td>no</td>
<td>somewhat - estate vulnerable</td>
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<tr>
<td>Outside Creditor Protection Issues at First Death</td>
<td>Increased creditor exposure of first to die's estate (if the estate is insolvent, e.g. wrongful death accident)</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
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<tr>
<td>10 Wrongful death lawsuit or major debt against 1st to die's estate could wipe out transferred assets</td>
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<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
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</table>

* 1014(e) application uncertain

**Technique to Get Full Step Up at 1st Death**

- **Transferring Gain**
- **Alaska/Tenn. Lifetime GPOA Testamatory Inter-Vivos Upstream Factors to Consider**
- **Property CP Trust Trust GPOA (JEST) Estate Trust Optimal Basis**
- **to ill spouse**
- **(Blattmachr, Zaritsky)**
- **(Blase)**
- **(Gassman)**
- **(Handler)**
- **(Morrow)**

**Factors to Consider**

- **Administrative Issues**
  - Need independent/corporate trustee in TN/Alaska
  - Settlor and/or settlor's spouse can be only trustees
  - Is irrevocable (for CP transfer, spouses can revoke half)
  - One year "curing period" required to achieve increase
  - Spouse can take some of transferred assets while living
  - Disinheritance risk if first to die has "2nd thoughts"
  - Potential substantial loss if spouses divorce after transfer (for CP Trust, to extent transferred property unequal)

**Outside Creditor Protection Issues During Life**

- Increased creditor exposure if lifetime creditors arise (including destruction of tenancy by the entireties)
- Increased creditor protection if lifetime creditors arise

**Outside Creditor Protection Issues at First Death**

- Increased creditor exposure of first to die's estate (if the estate is insolvent, e.g. wrongful death accident)
- Wrongful death lawsuit or major debt against 1st to die's estate could wipe out transferred assets

**Comparison of Basic Strategies for Step Up 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. 2014 version

"CP"="community property". "JEST"="Joint Exemption Step Up Trust" "GPOA"="general power of appointment"
## 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>Optimal Basis Increase Trust</th>
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</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>
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<td>no</td>
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<td>yes*</td>
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<td>13 U.S. Supreme Court (Harmon) case nearly on point against</td>
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<td>no</td>
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</tr>
<tr>
<td>15 Reciprocal gift issue if both spouses create cross-trusts</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>16 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>17 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>18 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>19 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

| - If asset value/market declines, "double" step down occurs - can be drafted around | yes | yes | yes | yes | yes | no |
| - unlikely | no | no | yes | yes | no | yes |

## Other Miscellaneous Issues

| Must be married (not registered partner, living together) * indicates non-married can use, but causes add’l taxable gift | yes* | yes | yes* | yes* | yes | no |
| Can get step up in basis upon older parent/relatives’ death (without using lifetime gift exclusion of donor upon death) | no | no | no | no | no | yes |

For articles on the above techniques other than the attached white paper, see I.R.C. §1014(e) and Gifted Property Reconveyed in Trust, 36 Akron Tax Journal 33, by Mark Seigal; Tax Planning with Community Property Trust, by J. Blattmachr and H. Zaritsky and M. Ascher; JEST Offers Serious Estate Planning Plus for Spouses (Parts 1 and 2), Estate Planning, Oct/Nov. 2013, by Alan Gassman, Christopher Denicolo and Kacie Hollendale; Estate Trust Revival: Maximizing Full Basis Step-Up, LISI Estate Planning Newsletter #2094, by David Handler; The Minimum Income Tax Trust, Trusts and Estates May 2014, by James Blase.
Comparison of Various Basic Trust Design Options for Married Couples

(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 has potential for Rev. Proc. 2001-38 step up denial)</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 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)</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</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 $12,150 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 (non-fiduciary) 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</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</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 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>

Comparison chart to article, "The Optimal Basis Increase and Income Tax Efficiency Trust" - please consult for explanation of variations

Companion chart to article, "The Optimal Basis Increase and Income Tax Efficiency Trust" - please consult for explanation of variations.
### Asset Protection Considerations

<p>| | | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<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</td>
<td>no</td>
<td>yes</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>if discretionary</td>
<td>no</td>
<td>no</td>
<td>yes</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>
<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>
<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>
<td>yes</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>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>17</td>
<td>Inherited assets escape estate tax at 2nd death</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>18</td>
<td>Allows dynastic GST use at first death (reverse QTIP)</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>19</td>
<td>No need for timely filed 706/portability to exploit 1st decedent spouse's $5.34m+ estate/GST exclusion</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>20</td>
<td>Can save millions in add'l estate tax in event of simultaneous death if one spouse's estate &gt; $5.34m+</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>21</td>
<td>Surviving spouse can remarry w/o jeopardizing first spouse's use of exclusion (i.e losing DSUE amt)</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>22</td>
<td>Enables disclaimer funding while still keeping a POA</td>
<td>n/a</td>
<td>no</td>
<td>yes</td>
<td>yes</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>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>23</td>
<td>Inherited assets escape state estate tax at 2nd death (to extent of exclusion, if not separate state QTIPed)</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>24</td>
<td>Ability to spray income to beneficiary in lower tax bracket or lower tax state</td>
<td>no</td>
<td>if added</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>25</td>
<td>Ability to shelter trust income from state income tax for trust income (incl CG) not K-1'd to beneficiary</td>
<td>no</td>
<td>maybe</td>
<td>maybe</td>
<td>maybe</td>
<td>maybe</td>
</tr>
</tbody>
</table>

See separate article on avoiding Ohio Trust Tax

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Email: edwinmorrow@msn.com or edwin_p_morrow@keybank.com
**Comparison of DAPT v. Lifetime Limited Power of Appointment (LLPOA) Trust Design Options**

**Key Features**

**How Donor Could Access Funds Post-Transfer**

<table>
<thead>
<tr>
<th></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 Settlor is not bene</th>
<th>Non Self-settled Power Trust w/LLPOA that is also OLT Settlor is not bene</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>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>
</tr>
<tr>
<td>2</td>
<td>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>
</tr>
<tr>
<td>3</td>
<td>Possible grounds for suit from benes if all funds revert to settlor</td>
<td>n/a</td>
<td>yes</td>
<td>no</td>
</tr>
</tbody>
</table>

**Gift Taxation of Any Donor Access Post-Transfer**

<table>
<thead>
<tr>
<th></th>
<th>Taxable gift if funds come back to donor (if trust is designed as an incomplete gift)</th>
<th>Taxable gift if funds come back to donor (if trust is designed as a completed gift)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
</tr>
</tbody>
</table>

**Ongoing Income Tax Treatment and Flexibility**

<table>
<thead>
<tr>
<th></th>
<th>Easy to Structure as a Grantor Trust</th>
<th>Easy to Structure as a Non-Grantor Trust</th>
<th>Non-Grantor Trust, could spray income post-transfer</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>n/a</td>
<td>no, but see ING PLRs</td>
<td>yes, if qualified</td>
</tr>
<tr>
<td>7</td>
<td>n/a</td>
<td>yes, if LLPOA PH is adverse (a benef)</td>
<td>yes, if LLPOA PH is adverse (a bene)</td>
</tr>
</tbody>
</table>

**Gift Tax Treatment and Flexibility**

<table>
<thead>
<tr>
<th></th>
<th>Easy to Structure as an incomplete gift</th>
<th>Easy to Structure and ensure a completed gift (for married donor - is it complete if spouse as creditor can access?)</th>
</tr>
</thead>
<tbody>
<tr>
<td>9</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>10</td>
<td>yes</td>
<td>no, but possible, see PLRs</td>
</tr>
</tbody>
</table>
### Estate/GST Tax Treatment and Flexibility

| 11 | Completed Gifts Remain Outside of Estate, no §2036 issue (though there is always "prearrangement"/"understanding" risk) | yes | unclear, and PLRs will not address | yes | yes |
| 12 | Could double as inter-vivos QTIP to exploit "poorer spouse" funding and use $5.43 million GST via reverse QTIP | n/a | no | yes, if LLPOA is inactive < SS’s death | yes, if LLPOA is inactive < SS’s death |
| 13 | Can help protect special self-settled trusts (CRT, QPRT, GRAT) by protecting grantor's retained income/unitrust | n/a | yes | n/a | n/a |

### Asset Protection Considerations

| 14 | In discovery/bankruptcy filing - must disclose being beneficiary | n/a | yes | no | no |
| 15 | Clear that 11 USC §548(e) 10 year FT SOL could apply (Mortensen, Huber cases) | n/a | yes | no | no |

| 16 | Court potentially "freezing out" settlor/beneficiary (Grant case) | n/a | yes | no | no |
| 17 | Exception creditors of settlor can reach assets even if there is no fraudulent transfer, by spendthrift exception | no | yes | no | no |
| 18 | Shorter SOL, tougher fraudulent transfer standards apply to help donor and deter later creditors (nonbankruptcy) | no | yes | no | yes |

| 19 | Requires Affidavit of Solvency for all Transfers | no | yes | no | no |

| 20 | Potential Medicaid/govt benefits advantage > 5 yrs | yes | no | unknown | unknown |
| 21 | Greater chance of other state law applying in conflict | n/a | yes | no | no |
| 22 | Strong chance of continued creditor protection even if out of state (non-DAPT) law held to apply | n/a | no | yes | yes |

### State (Ohio) Income Tax Features

| 23 | Chance of Federal Tax Lien attaching to Settlor as beneficiary | n/a | yes | no | no |
| 24 | Property is subject to beneficiary’s creditors (absent 5% power, mandatory interest or termination date, etc) | yes | no | no | no |

| 25 | 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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# Comparison of Various Trust Income Tax Shifting Options to Avoid Trapping Income in Trust

This chart discusses a bypass trust or other irrevocable non-grantor trust, NOT a marital, QSST or other trust that requires all net income paid. Assumes beneficiaries are not in top income tax bracket. 678a power assumes all income, rather than up to 5% (which might eliminate a few issues). LLPOA=lifetime limited power of appointment

<table>
<thead>
<tr>
<th>Requirement of Distributions</th>
<th>678(a) Mallinckrodt Beneficiary withdrawal</th>
<th>1.643(a)-(3)(b)(1) Treat CG as Accounting Income/DNI</th>
<th>1.643(a)-(3)(b)(2) CG distributed books records tax returns</th>
<th>1.643(a)-(3)(b)(3) actually distrib. or trustee uses determine amt</th>
<th>642(c) Charitable Deduction</th>
<th>Discretionary in kind distribution of unrealized gain asset (643e)</th>
<th>Placing assets in an S corp and QSST election</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual Distributions must be made to shift income (caveat, for &quot;simple&quot; trusts requiring income to be paid some income may be shifted even if distribution not made)</td>
<td></td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Can utilize 65 day election to make late distributions (e.g. allowing early 2014 distributions to count as 2013 distr)</td>
<td></td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>n/a</td>
</tr>
<tr>
<td>Can utilize 1 year election to make late distributions (allowing any 2014 qualifying distribution to count as 2013)</td>
<td></td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
</tbody>
</table>

## Timing of Distributions

1. Can change year to year with trust protector/decanting or valid amendment to change governing instrument
2. Can be used in conjunction with LLPOA/spray power
3. Ability to shift capital gains as well as other income
4. Ability to spray ongoing business income

## Ongoing Income Tax Treatment and Flexibility

1. Can change year to year with trust protector/decanting or valid amendment to change governing instrument
2. Can be used in conjunction with LLPOA/spray power
3. Ability to shift capital gains as well as other income
4. Ability to spray ongoing business income

## Asset Protection Considerations

1. Subjects applicable income to creditors of beneficiary & more likely to be “available” if beneficiary divorces
2. Trustee discretion protects from abuse/undue influence
3. Trust might require veto/consent of various parties to curtail extraordinary unwarranted distributions

### Companion chart to article, “The Optimal Basis Increase and Income Tax Efficiency Trust” - see p74-75 for further explanation of variations below
<table>
<thead>
<tr>
<th>Feature</th>
<th>Yes</th>
<th>No</th>
<th>No</th>
<th>No</th>
<th>No</th>
<th>No</th>
<th>No</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Federal Estate/Gift/GST Tax Features</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estate inclusion of income/ withdraw right via IRC 2041</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>ETIP Issue? If lapse, is GST used? (?? look into)</td>
<td>??</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>Gift tax possible if income released/assigned/appointed</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Unwithdrawn Income subject to 2036 inclusion (&gt;5%)</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes (stub QSST)</td>
</tr>
<tr>
<td><strong>Special Asset Tax Features</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&quot;See Through&quot; IRA Trust (401(a)(9)) and QSST (S corp)</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Requires carve out from POAs to prevent distributions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Can distribute &quot;blackacre&quot;, assets in kind to shift income w/o</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>probably not</td>
<td>no</td>
<td>n/a</td>
<td>n/a</td>
<td>yes</td>
</tr>
<tr>
<td>triggering the unrealized gain in the asset</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Section 179(d) expensing advantage (research)</td>
<td>yes</td>
<td>probably not?</td>
<td>probably not?</td>
<td>probably not?</td>
<td>no</td>
<td>n/a</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Can shift S Corp income to lower rates (assume &gt; estate)</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>n/a</td>
<td>yes</td>
</tr>
<tr>
<td>Can except muni/tax exempt income to keep in trust</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>n/a</td>
<td>yes</td>
</tr>
<tr>
<td><strong>State Estate &amp; Income Tax Features</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allows &quot;above the line&quot; deductions in many states</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>Easily change to trap income to escape state income tax (e.g. if</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>beneficiary later changes to high federal bracket)</td>
<td>(unless power removed) yes, for CG or more if no distributions</td>
<td>yes, but not for CG unless no distributions</td>
<td>yes, for CG or more if no distributions</td>
<td>n/a</td>
<td>yes</td>
<td>no</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Trustee Issues, Tax Accounting, Administration</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Failure to withdraw/distribute income complicates filing (is</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>remaining trust a partial grantor trust under 678a?)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Easy for trustee to determine/administer</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td></td>
</tr>
<tr>
<td>Requires very competent trustee and/or accountant</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
</tbody>
</table>

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Email: edwinmorrow@msn.com or edwin_p_morrow@keybank.com
### Comparison of Basic Strategies to Achieve Step Up at 2nd Spouse's Death for 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"

#### Factors to Consider

<table>
<thead>
<tr>
<th>Administrative Issues</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>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>
</tbody>
</table>

#### Keeping Fidelity to the Estate Plan of Settlor

| 5 Spouse can completely redirect/spend all assets                                    | yes                                                    | no                               | no                                         | no                                      | no                                            |
| 6 Disinheritation risk if spouse has "2nd thoughts"                                  | yes                                                    | no                               | no                                         | yes                                    | no                                            |
| 7 Susceptible to undo influence                                                      | yes                                                    | depends                          | much less                                   | depends                                 | much less                                     |

#### Creditor Protection Issues During Spouse's Life

| 8 Increased creditor exposure if lifetime creditors arise (no exclusion from bankruptcy estate under 11 USC §541) | yes                                                    | no                               | no                                         | no                                      | no                                            |
| 9 Exposure to commingling, division in divorce if remarried                           | yes                                                    | no                               | no                                         | no                                      | no                                            |
| 10 Consideration as "resource" for Medicaid qualification                             | yes                                                    | no*                              | no*                                        | no*                                    | no*                                           |

*depends on trust, discretionary WDT or income/HEMS, etc

#### Creditor Protection Issues at Second Death

| 11 Increased creditor exposure of second to die's estate (if the estate is insolvent, e.g. wrongful death accident) | yes                                                    | no                               | no                                         | no*                                    | no (unless UPOAA)                               |
| 12 Exposure to spousal elective share if spouse remarries                               | yes                                                    | no                               | no                                         | no                                      | no                                            |
## Comparison of Basic Strategies for Step Up In Basis at 2nd Spouse's Death for Bypass Trusts - Page 2

### Factors to Consider (page 2)

<table>
<thead>
<tr>
<th>Potential Tax/Legal 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>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>Yes, 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>There is no direct on point case or ruling on technique</td>
<td>no</td>
<td>yes [But, statute, regs, articles]</td>
<td>yes</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>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>no</td>
<td>no</td>
</tr>
<tr>
<td>Spouse could &quot;win lotto&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>Spouse could move to a state with separate estate tax (or, Ohio could resurrect its ET) Typically 12-20% tax</td>
<td>yes</td>
<td>no</td>
<td>unlikely</td>
<td>unlikely</td>
<td>unlikely</td>
</tr>
<tr>
<td>Potential taxable gift by remaindermen</td>
<td>yes</td>
<td>no</td>
<td>unlikely</td>
<td>unlikely</td>
<td>unlikely</td>
</tr>
<tr>
<td>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

| If asset value/market declines, step down occurs | yes | yes | no | yes | no |

### Other Income Tax Benefits IF Trust Amended

| Ability to shift income to beneficiary's low/0% tax brackets | no | yes | yes | yes | yes |
| Ability to deduct charitable gifts from Ohio income tax | no | yes | yes | yes | yes |
| Ability to efficiently defer income via distribution to CRUT | no | yes | yes | yes | yes |
| 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) | no | yes | yes | yes | yes |

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