Selecting Trustees and Structuring Trustee Powers: Guidance for Estate Planners on Tax and Non-Tax Consequences

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Today’s faculty features:

Sasha A. Klein, JD, LLM, Senior Vice President, Director of Trusts & Wealth Services, Sabadell Bank & Trust, Palm Beach, Fla.

Mark R. Parthemer, Managing Director and Senior Fiduciary Counsel, Bessmer Trust, Palm Beach, Fla.

Jordan D. Veurink, Attorney, Lindquist & Vennum, Sioux Falls, S.D.

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The avoidance of taxes is the only intellectual pursuit that still carries any reward.

- John Maynard Keynes
Preface - Four Foundational Tax Rules

Part 1 – Four Beneficiary Issues
Part 2 – Two Planning Considerations
Part 3 – Nine Donor Issues
Part 4 – Five Non-Tax Considerations
Part 5 – All “Four” One
Conclusion
Foundational Rule #1 – Section 2041

Gross estate includes the value of all property to which the decedent:

1. At death had a general power of appointment.

2. At any time exercised or released such a power by a disposition which if it were a transfer of property owned by the decedent, would be includible in the decedent’s estate under §§2035 – 2038, inclusive.
Definition – General Power of Appointment

A power exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.

Exceptions include:

- A power…limited by an ascertainable standard relating to the health, education, support, or maintenance. §2041(b)(1)(A).

- A power only exercisable in conjunction with (a) the grantor of the power or (b) someone with an adverse interest. §2041(b)(1)(C).
Foundational Rule #2 – Section 2036

Gross estate includes the value of all property to the extent the decedent made a transfer outright or in trust and retained:

- Possession or enjoyment of, or the right to the income.
- The right (alone or in conjunction with any person) to designate the persons who shall possess or enjoy the property or its income.

Exception:

✓ A bona fide sale for a full and adequate consideration §2036(a).
Foundational Rule #3 – Section 2038

Gross estate includes the value of all property to the extent the decedent made a transfer outright or in trust and either:

- Retained power, alone or in conjunction with any person to alter, amend, revoke, or terminate enjoyment of the property.
- Relinquished such a power within 3 years of death.

Exception:

- A bona fide sale for a full and adequate consideration §2038(a),(b).
### Estate Tax Comparison

<table>
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<tr>
<th>IRC</th>
<th>Amount</th>
<th>Origination</th>
<th>Contingency Impact</th>
<th>Ascertainable Std. Exception</th>
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<td>Entire</td>
<td>Retained power</td>
<td>None, includible</td>
<td>Case law</td>
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<tr>
<td>§2038</td>
<td>Only over which power is held</td>
<td>From any source</td>
<td>Yes, excluded</td>
<td>Case law</td>
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<tr>
<td>§2041</td>
<td>Amount</td>
<td>From any source</td>
<td>Yes, excluded</td>
<td>Statutory</td>
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Foundational Rule #4 – Section 672

**Adverse party under §672(a):**

Has a:

- Substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust, or

- A general power of appointment over the trust property.

**Related or subordinate party §672(c):**

A nonadverse party who is—

- The grantor’s spouse if living with the grantor.
- The grantor’s father, mother, issue, brother or sister.
- An employee of the grantor.
- A corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control.
- A subordinate employee of a corporation in which the grantor is an executive.
Four Foundational Tax Rules

Part 1 – Four Beneficiary Issues

Part 2 – Two Planning Considerations

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Part 5 – All “Four” One
Beneficiary Issue #1 – Distribution To Others

A beneficiary/trustee should not have broad discretion to distribute:

☑ To others.

Example: Tom is trustee and is empowered to distribute to his siblings for their “health, support, maintenance or happiness.” A distribution under this power will be:

1. A gift, if Tom is also a current beneficiary.
2. Probably a gift, if Tom is not a current, but is a remainder beneficiary.
3. Unresolved – Tom could distribute to himself, but does not.

Limit distribution standard for all beneficiaries to HEMS, use an Independent Trustee for anything broader.
Beneficiary Issue #2 – Distribution To Self or In Satisfaction of a Support Obligation

A beneficiary/trustee should not have broad discretion to distribute:

✓ To herself.
✓ In satisfaction of her personal legal support obligation of another.

Example: Ann died in 2004. Husband’s Will (DOD 1989) created a credit shelter trust, Ann and a bank were co-trustees with distribution power for the “necessary maintenance, education, health care, sustenance, welfare or other appropriate expenditures needed by (Ann, children and grandchildren) taking into consideration the standard of living to which they are accustomed…” Estate of Ann Chancellor v. Commissioner, TC Memo 2011-172.

A slight change in language can be critical!
Power to reimburse debts, expenses or taxes can cause inclusion.

Example: H & W create joint revocable trust. H dies, resulting in three trusts: Spouse’s trust (W’s original assets), credit shelter trust and marital trust. New attorney handling estate notices reference for reimbursement clause of surviving spouse’s debts, taxes and expenses is to credit shelter trust paragraph. This results in a GPOA in wife, forcing credit shelter trust assets to be included in her estate. Consider PLR 201132017.
Beneficiary Issue #4 – Power to Remove/Replace Trustee

Authority of beneficiary to remove/replace trustee could create a general power of appointment. If properly restricted (ascertainable standard and prohibition from satisfying support obligation), no inclusion regardless who serves.

Example: Grantor authorizes beneficiary to remove and replace trustee. Trustee may distribute without limitation. Beneficiary dies before trust is funded. Possible inclusion via GPOA by logical extension of TAM 9125002.
Four Foundational Tax Rules
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Planning Consideration #1 – State Law

States literally are “all over the map” on trust related laws, including:

- Creditor rights.
- Income taxation.
- RAP.
- UTC, UPIA, UPAIA, and other administrative provisions.
- Directed trusts/unique asset provisions.

✓ Drafting Pointer: If any creditor concerns, do not have beneficiary serve as trustee.

Example: NY resident grantor creates a grantor “dynasty” trust with spouse as trustee and son, a California resident, as successor trustee. Should the planner consider a situs without state income tax?
Most states have enacted laws “just in case” not in governing document. These indeed can be a saving grace…but be careful to rely on them as a default because:

1. Trustee may relocate trust.
2. Successor may be in a state without such statutory safeguards.
3. Default law may change during term of the trust.

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Grantor Issue 1 – Completed Gifts

• A gift is subject to transfer tax at its value when the gift is completed.

• If incomplete, the "gift" is included in donor's estate under IRC § 2036 or § 2038.

• The key is whether the gift is complete or incomplete.
  
  – **Example:** Chris creates and contributes assets into an irrevocable trust. He is sole trustee. The trust provides that the trustee may distribute in its sole discretion to, or for the benefit of, a class of beneficiaries including himself, and his children. Because Chris is the donor and as trustee, retains the right to control and receive distributions, the gift is incomplete and is includable in Chris' Estate.
Grantor Issue 2 – Retained Rights

• Retained right to possession or enjoyment, or income from, property will cause inclusion regardless of who is trustee.

• Grantor as Trustee:
  – A transfer is a completed gift only to the extent that 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.” Treas. Reg. § 25.2511-2(b).
  – If a gift is incomplete to the extent that the donor reserves the power to revest the property in himself. Treas Reg. § 25.2511-2(c).

• Independent Trustee:
  – If an independent trustee is making the distribution decision, which must be purely discretionary (no ascertainable standard), then Grantor may be a beneficiary.
Grantor Issue 2 – Retained Rights

• Right to use trust property:
  – If the donor has the right to actual use of trust property or trust income clearly comes within the meaning of IRC § 2036, regardless of who is serving as trustee.

• Implied understanding:
  – The statute also applies if there is an implied understanding that the grantor will be allowed to use or receive income from the transferred property. The implied agreement may be “an understanding, express or implied, that the interest or right would later be conferred.” Treas. Reg. § 20.2036-1(c)(1) .
Grantor Issue 2 – Retained Rights

• **Examples:**
  - IRC § 2036 was applied on the basis of an implied agreement where the trustee had the discretion to make distributions to the grantor and others, but distributed all of the income to the grantor for his lifetime.
  - Decedent transferred almost all assets to an FLP, used assets to pay personal expenses, received disproportionate distributions, and then assets used to pay his estate tax. See Estate of Liljestrand, T.C. Memo. 2011 – 259.
  - What if sale of FLP interests is attacked under a step-transaction doctrine and the consideration received is deemed insufficient? See Pierre v. Commissioner, T. C. Memo. 2010 – 106. The IRS may argue that the entire transaction should be pulled into grantor's estate.
Grantor Issue 3 – Absolute Discretion

• IRC § 2036 may apply if donor is trustee and has:
  – Broad power to make distributions to others; or
  – Any power to distribute...
    • To himself or herself. IRC § 2036(a)(1)).
    • In satisfaction of his/her own obligations. Treas. Reg. § 2036-1(b)(2); Hooper v. Comm’r, 41 B.T.A. 114 (1940).
    • In satisfaction of own his/her support obligations. Treas. Reg. § 2036-1(b)(2).

• If no ascertainable standard limitation, prohibit donor from ever serving as trustee.
Grantor Issue 4 – Absolute Administrative Power

• Administrative decisions may effectively shift benefits among beneficiaries, potentially triggering estate inclusion under IRC § 2036(a)(2).
• Drafting Pointer: Do not draft around court oversight or fiduciary duties. A grantor’s broad management powers will not invoke IRC § 2036 or 2038 as long as the grantor’s actions are subject to review by a court of equity.
Grantor Issue 4 – Absolute Administrative Power

• Examples

  – Income-only inter vivos marital trust empowers the trustee to adjust between principal and income. Grantor is trustee. Second wife is current beneficiary; kids from first marriage are remainder beneficiaries. What if power was to allocate receipts/disbursements? Even broad authority to allocate receipts and disbursements between income and principal will not trigger IRC §§ 2036 or 2038. See Old Colony Trust Co. v. U.S., 423 F.2d 601, 604 (1st. Cir. 1970); Estate of Budd v. Comm’r, 49 T.C. 468 (1968).

  – Taxpayer establishes FLP and retains GP interest. GP may declare distributions, including distributing in kind, and unilaterally may amend partnership agreement. Court held that the decedent retained the right to designate which person or persons would enjoy the transferred property, which would cause estate inclusion under § 2036(a)(2). Turner v. Comm’r, T.C. Memo. 2011 – 209.
Grantor Issue 5 – Prohibited Powers

• Three historically problematic grantor trust powers:
  – Arguable – swapping shares of a controlled corporation. The issue is whether the power to reacquire such stock is the equivalent of a retained right to vote the stock indirectly, pursuant to IRC § 2036(b)(1).
    • In PLR 200603040, the IRS ruled that a general swap power held in a fiduciary capacity would not cause inclusion under IRC § 2036.
    • In Revenue Ruling 2008-22, the IRS ruled that, if certain requirements are met, retention of a swap power held in a nonfiduciary capacity will not result in inclusion under IRC § 2036.
  – Possible – toggle of grantor powers on and off vested in grantor. While the grantor may generally be given one power (i.e., the power to toggle the grantor status off) another person should be given the opposite power, to avoid giving the grantor a deemed ability to amend the trust.
Grantor Issue 5 – Prohibited Powers

• **Example**: Grantor creates an irrevocable grantor-defective trust and gifts 50% of Corp. A to the trust, retaining 50%:
  – What if Grantor is trustee?
    • Problematic pursuant to IRC § 2036(b), due to the retained right to vote the shares.
  • What if trust company is trustee?
    – No issue with IRC § 2036(b), assuming Grantor doesn't retain voting rights.
  • Either way, Grantor should consider whether he or she should have ability to substitute the power to swap shares.
Grantor Issue 6 – Power to Remove and Replace

- Grantor can have power to remove and replace with a trustee that is not related or subordinate to the Grantor. See Revenue Ruling 95-58.
- To stay within the "safe harbor" and avoid IRC §§ 2036 and 2038, the Grantor should not have the power to remove and replace trustee with someone related or subordinate, although Estate of Wall v. Comm’r, 101 T.C. 300 (1993) does appear to allow for this.
- Grantor should never have the power to appoint himself/herself as trustee, or powers will be imputed to Grantor. If powers are imputed to Grantor, will cause inclusion of trust assets in Grantor's estate.
Grantor Issue 6 – Power to Remove and Replace

• **Example:**
  - Trustee had absolute discretion to distribute to beneficiaries (even grantor). Grantor could remove any trustee at any time, with or without cause, and appoint an independent successor trustee (within the meaning of §672(c)). The grantor’s unlimited power to remove the trustee and appoint a successor independent trustee (who was not a related or subordinate party under Section 672(c)) did not prevent the grantor from making a completed gift when the transfer to the trust was made. *Estate of Vak v. Commissioner*, 973 F.2d 1409 (1992); adopted in Rev. Rul 95-58.
Grantor Issue #7 – Minor’s Trusts under §2503(c)

Tax trap:

- If donor dies while serving as trustee, assets includible in estate.
- 3 year look-back under §2035(a).
- Perhaps worse if appoint spouse as trustee:
  - If spouse dies while trustee, includible due to assets available to satisfy legal support obligation.
  - If spouse is alive when minor turns 21, there may be a taxable lapse of a GPOA.

Example: Problematic provisions in a §2503(c) trust:

- Trust distributions limited, perhaps to child’s education or health care.
- Distributions restricted by ascertainable standard.
- Distributions restricted to prohibit payment of a trustee’s support obligation (but see *Upjohn v. U.S.*, 72-2 USTC 12,888 (W.D. Mich. 1972)).
Grantor Issue #8 – Foreign Trust Status

To avoid income tax characterization of foreign trust, do not have foreign person(s) as 50% or more trustees. §679.

Example: Grantor appoints her two children as trustees, one of whom is not a US citizen and who lives outside the US, and grants power to:

- Make distributions of a sprinkle trust.
- Make principal/income allocations.
- Make investment decisions.
- Compromise claims against or by the trust.
- Remove, add or replace a trustee.
Grantor Issue #9 – Grantor Trust Status

Plan for, or around, grantor trust triggers.

Rev. Rul. 2004-64. Tax reimbursement clauses:
- Mandatory will cause assets to be included in the grantor’s estate under §2036(a)(1).
- Discretionary may not…or may, depending on facts (e.g., implied understanding).

Example: Sample GRAT provision: I intend that during the Term I will be treated as the owner of the trust estate for income tax purposes. I further agree that the trustee shall be specifically prohibited from making any reimbursement to me for any such income taxes.
Four Foundational Tax Rules

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ESTATE PLANNING

YOU CAN AVOID PROBATE COSTS BY CREATING A LIVING TRUST.

SO... I CAN USE AN INCONVENIENT SYSTEM CREATED BY LAWYERS TO AVOID A WORSE SYSTEM CREATED BY LAWYERS?

ACCORDING TO MY WATCH, THAT WITTY OBSERVATION COST YOU FOUR DOLLARS.
Non-Tax Consideration #1 – Legal Capacity

Capacity:

Individuals - Legal age; competency.
Corporations - Trust powers (N.A. or state qualified); other qualifications imposed by agreements, such as size minimums:
- Capital (historical measurement).
- AUM, or assets under management (trend).

Example: Client lives in Florida and seeks to put all assets, including her home, in a Revocable Trust, and appoint as successor co-trustees:

- Her 17 year-old daughter,
- ABC Federal Credit Union, and
- Local Bank, San Antonio, TX.
Non-Tax Consideration #2 – Personal Attributes

In addition to those of highest integrity and impartiality, also consider:

- Locality.
- Ability to grasp purpose of trust.
- Sophistication to handle trust assets.
- Fortitude to manage difficult beneficiaries or circumstances.

Examples:
1. Should child of first marriage be trustee of step-mother’s marital trust?
2. Mom creates GST Exempt grantor trust and sells gold bullion, bitcoin, and concentrated stock positions. Dad prefers to play golf, not watch the market, and dislikes limiting nature of trusts. He wants to distribute the trust assets to their children outright. Is Dad a good choice for trustee?
Non-Tax Consideration #3 – Likelihood of Self-Dealing

Fiduciary duty of loyalty is designed to protect, but casts a wide net.

State law “work-around” often cumbersome, even if exists. Thus, consider language in document.

**Example:** Client seeks to appoint Bank & Trust Company as trustee and executor:

- Bank & Trust Company provides investments through an affiliated company.
- Estate will be illiquid and client intends for executor/trustee to borrow from Bank & Trust Company to pay estate tax.
Non-Tax Consideration #4 – Situs Selection

It can be possible to “forum shop” and select a situs suitable for the nature and purpose of the trust. Some argue this is a trustee duty.

Examples:
1. Client seeks to create a dynasty trust with portfolio assets and stock in a family owned business. Client wants an independent trustee, yet doesn’t want to give up family control of business.
2. Client wants to create a self-settled domestic asset protection trust.
3. Income beneficiaries request trustee to make an adjustment under a power to adjust…see next slide.
Non-Tax Consideration #5 – Know Thy Trustee’s Jurisprudence

Rendering discretion is part art, part science.

- Distributions - balance distributions and asset allocation; which, if any, beneficiaries get preferential distributions and whether document or state law require consideration of resources.

- Decanting.

- Allocation of receipts and disbursements.

- Power to adjust - state law/situs question…BUT, power is not distribution authority, but investment.

Example: Income-only marital deduction trust for remainder beneficiary’s step-mother. She needs 4% to sustain her life style. Options may include investment allocation, conversion to a unitrust, and use of the power to adjust.
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All “Four” One? – Decanting

• Where permitted, decanting laws are generally allowed by statute.
• Statutes require an independent trustee:
  – Some statutes only permit when an absolute discretion standard.
  – Some allow even when ascertainable standard.
• Questions trustees must ask:
  – Can the trustee decant?
  – Should the trustee decant?
  – What are the tax implications of decanting?
All “Four” One? – Decanting

• What are the tax implications of decanting?
  – **Income Tax** - Decanting generally doesn’t result in a realization event for the distributing trust if the decanting is authorized by either the trust’s governing instrument or state law.
  – **GST Tax** - There is no law directly on point. It appears that the receiving trust should have the same inclusion ratio as the transferor trust under IRC § 2654(b) provided that the receiving trust doesn’t extend the time for vesting or shift beneficial interests to a lower generation.
  – **Estate/Gift Tax** – Treas. Reg. § 25.2512-8 suggests that if a beneficiary consents to or acquiesces in a decanting that reduces the beneficiary’s interest, the beneficiary has made a taxable gift. However, the regulations under IRC § 2511 require a voluntary act to have a taxable gift.
    • No relief from IRS to clarify this point – decanting remains on the “no ruling” list for gift, estate and GST. Notice 2011-101; Rev. Proc. 2011-3.
Preface - Four Foundational Tax Rules

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Conclusion
I always want to say to people who want to be rich and famous: “try being rich first.” See if that doesn't cover most of it. There's not much downside to being rich, other than paying taxes and having your relatives ask you for money. But when you become famous, you end up with a 24-hour job.

- Bill Murray
Thank You

Sasha A. Klein, JD, LLM, Senior Vice President, Director of Trusts & Wealth Services
Sabadell Bank & Trust, Palm Beach, Fla.,
sasha.klein@sabadellbank.com

Jordan D. Veurink, Attorney
Lindquist & Vennum, Sioux Falls, S.D.,
jveurink@lindquist.com

Mark R. Parthemer, Managing Director and Senior Fiduciary Counsel,
Bessemer Trust, Palm Beach, Fla.,
parthemer@bessemer.com