ESTATE PLANNING FOR MARRIED COUPLES IN A WORLD WITH PORTABILITY AND THE MARITAL DEDUCTION

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I. INTRODUCTION

With the passage of the American Taxpayer Relief Act of 2012, P.L. 112-240, 126 Stat. 2313 (2013) ("ATRA"), the estate planning landscape has changed. We now have "permanent," unified estate, gift, and generation-skipping transfer ("GST") tax laws with some little twists, like portability. High transfer tax exemptions and a tick up in the transfer tax rate, which closed much of the gap between income and transfer tax rates, have caused estate planners to step back and refocus how they help clients plan their estates. It doesn't mean that we have had to throw out the estate planning toolbox and start over; it just means we have had to look at our tools with fresh eyes. In doing so, we find that, with a little polish, our existing tools can help our clients in new ways.

II. FEDERAL ESTATE, GIFT, AND GST TAX LAWS

A. Permanent, Unified Tax System

1. Historical Perspective. Prior to 2002, each person had a "unified" transfer tax credit which could be used to offset estate and gift taxes. IRC §§ 2010, 2505. This credit effectively sheltered a set amount of transfers (by gift or at death) without incurring any transfer tax. The Economic Growth and Taxpayer Relief Reconciliation Act of 2001, P.L. 107-16, 115 Stat. 38 (2001) ("EGTRRA") "de-unified" the estate and gift tax credit, with the estate tax exemption exceeding the $1 million lifetime gift tax exemption from 2004 through 2009. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312, 124 Stat. 3296 (2010) ("TRA 2010") re-unified the estate, gift, and GST tax exemptions, increasing them to $5 million for 2011, with an inflation adjustment in 2012. In 2013, the law was scheduled to revert to the law in effect in 2001, immediately prior to the enactment of EGTRRA.

2. American Taxpayer Relief Act of 2012, P.L. 112-240. ATRA was passed by Congress on January 2, 2013 and signed into law on January 4, 2013. ATRA adjusted tax rates and made the changes to the gift, estate, and GST tax exemptions first enacted in 2010 "permanent," while increasing the effective federal estate tax rate on the excess from 35% to 40%. As a result, we now have permanent, unified estate, gift, and GST tax laws with an exemption of $5,000,000, adjusted annually for inflation after 2010, and a top estate, gift, and GST tax bracket of 40%. For 2017, after applying the inflation adjustment, this exemption is $5,490,000. For reference, a chart outlining the estate, gift, and GST tax exemptions since 1916 is attached as Exhibit A. At the same time, federal income tax rates were increased for individuals, trusts and estates to 39.6% for ordinary income and 20% for qualified dividends and capital gain tax.

3. Permanency. As we all know, tax laws are never truly permanent. However, for the first time since 2001, there is no set expiration date for the estate, gift, and GST tax laws. Prior to 2013, there was continued uncertainty about "will they or won't they," while now, it literally takes an act of Congress to make a change. Now that we do have permanent laws, it is ever more important that existing testamentary plans be reviewed to ensure the amount that clients want to pass to their beneficiaries is the "right" amount. As the exemption amount continues to be adjusted for inflation, specific bequests tied to the exemption amount may become even trickier.

B. The Net Investment Income Tax


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1 This paper is written at a time when the current administration and Congress have generally discussed broad tax reform, without providing any substantive details about possible changes. As a result, the paper necessarily focuses on estate planning and administration under the law as it stands in June, 2017.

2 Of course, a client may make lifetime use of his or her GST tax exemption without making a corresponding taxable gift, or may make a taxable gift without allocating GST tax exemption. As a result, at death, the remaining amount of these exemptions may be unequal or out of sync.
2010") imposes an additional 3.8% income tax on individuals, trusts, and estates, and that tax began being imposed in 2013. For individuals, the tax applies to the lesser of net investment income or the excess of a taxpayer's modified adjusted gross income over certain defined thresholds. For individuals who are married filing jointly, the threshold is $250,000; for married filing separately, $125,000 each; and for single individuals, $200,000. For estates and trusts, the 3.8% tax applies to the lesser of undistributed net investment income or the excess of adjusted gross income over a threshold determined based on the highest income tax bracket for estates and trusts, which was $12,300 for 2015, $12,400 for 2016, and is $12,500 for 2017. When combined with the increase in income tax rates noted above, the additional 3.8% tax on net investment income yields a top tax rate of 43.4% on ordinary income and a top tax rate of 23.8% on capital gains and qualified dividends.

C. Portability

TRA 2010 added, and ATRA made permanent, the notion of "portability" of a deceased spouse's unused exemption amount. In essence, portability provides that upon the death of one spouse, the executor of that spouse's estate may file an estate tax return and elect on that return to allow the surviving spouse to effectively inherit any unused federal estate tax exemption of the deceased spouse. In other words, the deceased spouse's unused exemption amount can be "ported" to the surviving spouse. IRC § 2010(c)(2)(B). Final regulations were issued effective June 12, 2015 which provide guidance regarding portability. Treas. Reg. §§ 20.2010-2, -3. The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount," otherwise known as the "DSUE amount." Once a spouse receives a DSUE amount, the surviving spouse can use the DSUE amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her "last deceased spouse." A simple example illustrates this concept.

Example 1: H dies in 2011 with an estate of $3 million. He leaves $2 million outright to his wife W, and the balance to his children. As a result, his taxable estate is $1 million ($3 million, less a $2 million marital deduction). The executor of H's estate elects to file an estate tax return using $1 million of H's $5 million estate tax exemption to shelter the gift to the children, and pass (or "port") the other $4 million of H's estate

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3 For a more expanded discussion of portability, see Davis and Willms, Planning for Married Clients: Charting a Path with Portability and the Marital Deduction, 42nd ANN. NOTRE DAME TAX AND EST. PL. INST. (2016).

4 A "spouse" may include persons other than those ceremonially married in the jurisdiction in which the decedent died. For example, persons who are married under the common law of one jurisdiction may be recognized as married for federal tax purposes, even if they later move to a jurisdiction that does not recognize common law marriage. See Rev. Rul. 58-66, 1958-1 CB 60. In addition, same-sex couples who are lawfully married in the jurisdiction in which the marriage ceremony is celebrated will be considered spouses for all federal tax purposes, even if they reside in a jurisdiction that purports not to recognize same-sex marriage. United States v. Windsor, 133 S.Ct. 2675 (2013); Rev. Rul. 2013-17, 2013-38 IRB 201. Subsequent to the issuance of Revenue Ruling 2013-17, the U.S. Supreme Court ruled that the Fourteenth Amendment of the U.S. Constitution requires states to license marriages between two people of the same sex, and to recognize all marriages between two people of the same sex when their marriage was lawfully licensed and performed out-of-state. Obergefell v. Hodges, 135 S.Ct. 2584 (2015). As a result, the marriage of a same-sex couple that is lawful in the state in which the marriage was performed cannot be ignored in other states for purposes of applying their laws. The constitutional basis for this holding likely means that laws in states that purport to limit marriage to one man and one woman can never have had valid application. A discussion of this issue is beyond the scope of this paper. For convenience, some examples in this paper denote spouses as H and W. The IRS has issued Notice 2017-15, 2017 IRB 783 which outlines procedures to allow taxpayers and executors to recalculate remaining applicable exclusion amounts and GST exemption to the extent that exclusion amounts were used or exemption was allocated by a taxpayer lawfully married to a person of the same sex who the IRS did not treat as a spouse before the Windsor decision was issued. Unfortunately, the procedures outlined do not address the proper recomputation of adjusted taxable gifts, so further guidance is expected.
tax exemption to W. W would then have an estate and gift tax exemption of $9 million (her own $5 million exemption plus H's unused $4 million exemption).\(^5\)

As a result, married couples can effectively shelter up to $10.98 million (using 2017 figures) in wealth from federal gift or estate tax without utilizing any sophisticated estate planning techniques.

### D. New Vocabulary

TRA 2010 revised the vocabulary used for estate and gift purposes. To understand portability, it is helpful to have a good grasp of the terms used in the statute and regulations. The new terms are as follows:

1. **Basic Exclusion Amount.** Every individual has a basic exclusion amount equal to the federal gift or estate tax exemption in the year of the transfer. In 2011, this amount was $5 million. In 2016, the basic exclusion amount was $5.45 million, and in 2017, it is $5.49 million. IRC § 2010(c)(3).

2. **DSUE Amount.** As noted above, the "deceased spousal unused exclusion amount," or "DSUE amount" is the amount of a deceased spouse's exemption that passes to his or her surviving spouse when a valid portability election is made. IRC § 2010(c)(4).

3. **Applicable Exclusion Amount.** The applicable exclusion amount is the sum of one's basic exclusion amount, plus his or her DSUE amount, if any. IRC § 2010(c)(2).

4. **Executor.** The portability election is made by the "executor" of the deceased spouse's estate. IRC § 2010(c)(5)(A). If there is a court-appointed executor, that person is the executor (referred to in Treasury regulations as an "appointed executor"). If there is no court-appointed executor, any person in actual or constructive possession of property (a "non-appointed executor") may make the portability election.

5. **Last Deceased Spouse.** A surviving spouse may only use the exemption of the spouse's "last deceased spouse." IRC § 2010(c)(4)(B)(i). Under the Treasury regulations discussed below, "last deceased spouse" means "the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse." But as noted below, at various times based on the timing of transfers made by a surviving spouse, a person may have more than one "last deceased spouse." Treas. Reg. § 20.2010-1(d)(5). As a result, under some circumstances, a surviving spouse may use the DSUE amount of multiple last deceased spouses.

### E. Overview of Regulatory Provisions and Observations about Portability

1. **Temporary, Proposed and Final Regulations.** Temporary and proposed regulations regarding portability were issued on June 15, 2012. In addition, a few general regulations for Sections 2010 and 2505 of the Internal Revenue Code (the "Code")\(^6\) were also issued. (Interestingly, regulations were never previously issued for those statutes.) These regulations were finalized without substantial changes on June 12, 2015. The regulations primarily provide guidance regarding portability. The guidance covers a variety of issues including election requirements, details regarding computing the DSUE amount, and the surviving spouse's use of the unused exclusion amount (either by gift or for estate tax purposes following the surviving spouse's death). The temporary and proposed regulations apply to estates of decedents who died on or after January 1, 2011 and before June 13, 2015. The final regulations apply to estates of decedents dying after June 12, 2015. See TD 9725, IRB 2015-26.

The final regulations generally provide very taxpayer-friendly positions regarding several issues (surprisingly friendly in some cases). The final regulations also adopt reasonable positions, avoiding what would seem to be nonsensical results that might occur with respect to various issues under a literal reading of the portability statutes. Perhaps the specific authorization in Section 2010(c)(6) of the Code for the

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\(^5\) Although the surviving spouse's exemption amount would be adjusted each year for inflation, the $4 million DSUE amount would not. Unless stated otherwise, this paper assumes a $5 million exemption without adjustment for illustration purposes, to make the math easier.

\(^6\) References herein to "Section(s)" or to "Code" are to the Internal Revenue Code of 1986, as amended.
Secretary of the Treasury to prescribe regulations "necessary or appropriate to carry out [that] subsection" afforded comfort in interpreting the statutory language very broadly in order to reach reasonable results.

2. Making the Portability Election.

a. How to Get Portability. Section 2010(c)(5)(a) of the Code states that the DSUE amount is available to the surviving spouse only if the decedent's "executor" timely files an estate tax return on which the DSUE amount is computed and makes an election on the return for portability to apply.

b. Will Language Regarding Portability. Portability is relatively new and only recently permanent. Consequently, most existing wills and revocable trusts do not contemplate the possibility of preparing an estate tax return if the decedent's estate is not taxable. In most of these existing testamentary documents, no provision permits the executor to prepare the return and no provision directs whether the estate may or may not pay for the preparation of the return. It is easy to imagine situations where a conflict exists as to whether the return should be prepared, such as multiple beneficiaries of the decedent's estate or where the surviving spouse is not a beneficiary of the decedent's estate and the estate passes to the decedent's children (think blended families). After all, portability has the potential to benefit the beneficiaries of the surviving spouse's estate, who may not be the same as the beneficiaries of the decedent's estate. In certain circumstances, making the portability election may actually expose the beneficiaries of the first decedent's estate to unnecessary estate taxes (see the discussion of "The QTIP Tax Apportionment Trap" at page 30 below).

Estate planners should discuss the issues with their clients and consider adding language in testamentary documents to direct or prohibit the preparation of the return. In a case where such language had not been addressed, the surviving spouse entered into an agreement with the deceased spouse's daughter as executor in which the surviving spouse agreed to pay the expenses of filing an estate tax return to elect portability plus $5,000, in exchange for the daughter's agreement to give up all claims to tax benefits received from any returns filed by the surviving spouse and the estate. Both parties were represented by counsel. After the surviving spouse's death, daughter filed a claim in his estate seeking $500,000 for his use of the DSUE amount under the theory that his estate would otherwise be unjustly enriched by its lower estate tax liability. On summary judgment, the probate court found the agreement was controlling and unambiguous and that there was no unjust enrichment. In a memorandum decision marked not for publication, the Indiana Court of Appeals affirmed the probate court's decision. Walton v. Est. of Swisher, 3 NE 3d 1088 (Ind. App. 2014).

If language is included in testamentary documents providing that the return may be prepared, then the mechanics of doing so and how the associated costs will be paid should also be addressed. For example, as a starting point, one might consider adding language to the Will which provides, in effect:

My Executor may make the election described in Section 2010(c)(5) of the Code to compute my unused exclusion amount and thereby permit my spouse to take that amount into account. My Executor may incur and pay reasonable expenses to prepare and file any estate tax return or other documentation necessary to make such election, and to defend against any audit thereof.

-or-

If my surviving spouse so elects, and agrees to pay to or reimburse my estate for the reasonable costs incurred by my Executor in preparing and of filing an estate tax return required only to make the required election, my Executor shall make the election described in Section 2010(c)(5) of the Code to compute my unused exclusion amount and thereby permit my spouse to take that amount into account. My spouse shall advance or reimburse to my Executor all reasonable expenses necessary to prepare and file any estate tax return or other documentation necessary to make such election, and to defend against any audit thereof.

c. Timely Filed Estate Tax Return. Generally, a portability election must be made on a timely filed estate tax return (including extensions). IRC § 2010(c)(5)(a). The regulations make it clear that the last return filed by the due date (including extensions) controls. Subject to restrictions when more than one person may make the election (discussed below), before the due date, the executor can supersede the election made on a prior return. After the due date, the portability election (or non-election) is irrevocable. Treas. Reg. § 20.2010-2(a)(4).
The temporary and proposed regulations did not discuss whether so-called "9100 relief" to make a late election was available. However, the IRS issued Revenue Procedure 2014-18, 2014-7 IRB 513, providing a simplified method to obtain an extension of time to file for executors of estates of decedents who died after December 31, 2010 and on or before December 31, 2013, whose estates were not required to file an estate tax return under Code Section 6018, and who filed the return by December 31, 2014. The Revenue Procedure confirms that taxpayers failing to qualify for relief may, after January 1, 2015, request an extension of time to make an election by requesting a letter ruling seeking 9100 relief. Taxpayers with 9100 relief rulings pending when the Revenue Procedure was issued (January 27, 2014) were permitted to rely on the Revenue Procedure, withdraw their ruling requests, and receive a refund of their user fees, so long as the request was withdrawn before the earlier of IRS action on the request or March 10, 2014. Id. Pursuant to Treasury Regulation Section 20.2010-2(a)(1), the final regulations confirmed that for an estate that is not required to file an estate tax return under Section 6018(a), 9100 relief could be sought, and that 9100 relief would not be granted for an estate required to file a return under that section.

Since the expiration of the simplified relief procedures of the 2014 revenue Procedure, numerous private letter rulings have been requested and given granting an extension of time to file in order to make the portability election for estates not required to file a return under Section 6018(a). See, e.g., PLRs 201551008; 201703001. As expected, no rulings have permitted a late portability election for an estate that was over the estate tax filing threshold, even if no estate tax was due.

Because of the influx of ruling requests, to remove some of the burden to taxpayers and the IRS, the IRS issued Revenue Procedure 2017-34, 2017-26 IRB 1282, effective as of June 9, 2017, to provide a simplified method to extend the time for filing an estate tax return for estates that are not required to file a return under Section 6018(a) and who have not already filed a return. For all such estates of decedents dying after December 31, 2010, a complete and properly prepared return will be considered to be timely filed, if it is filed by the later of (i) January 2, 2018 or (2) two years after the decedent's date of death. In order to qualify for relief under the revenue procedure, at the top of the return must be written "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)." Filing an estate tax return in accordance with the revenue procedure is deemed to be the equivalent of 9100 relief. Note that if the estate has already timely filed an estate tax return, the method is not available and any election regarding portability set out in that return cannot be changed. In addition, if the return is filed and results in an increase of the exclusion amount available to the surviving or the surviving spouse’s estate and such increase would have resulted in a decrease in gift or estate tax paid by the surviving spouse or his or her estate, a refund for any overpayment will only be paid if the statute of limitations for making a claim or seeking a refund has not expired. In other words, relief under the revenue procedure only provides an extension of time to file the estate tax return itself, although if a claim is made before the estate tax return is filed in accordance with the revenue procedure, the claim will be treated as a protective claim for refund. Furthermore, if a taxpayer does not qualify for the relief provided, the taxpayer may still seek 9100 relief. Note that for estates that qualify, following the revenue procedure is the only way to obtain relief because 9100 relief will not be granted for those estates. In addition, for estates where 9100 relief is still pending on June 9, 2017, those files will be closed, the user fee refunded, and relief is to be obtained under the revenue procedure.

d. Election on Return. The election is made by filing a "complete and properly-prepared" estate tax return. Treas. Reg. § 20.2010-2(a)(2). There is no box to check or statement to attach to the return to make the election. Part 6 on page 4 of IRS Form 706 provides, "A decedent with a surviving spouse elects portability of the deceased spousal unused exclusion (DSUE) amount, if any, by completing and timely-filing this return. No further action is required to elect portability of the DSUE amount to allow the surviving spouse to use the decedent's DSUE amount." Part 6, Section A of Form 706 also includes a box to check to opt out of portability. Of course, another way of not making the election for estates below the filing threshold is to simply not file a return. Treas. Reg. § 20.2010-2(a)(2)-(3). When the Treasury was drafting its regulations, some comments asked them to give guidance about protective portability elections. For example, if there is a will contest, the DSUE amount may depend on who wins the contest. Until the contest is resolved, there may be no way of knowing who the executor is, or even who is in actual or constructive possession of property unless the court appoints a temporary executor. The regulations have no discussion of protective elections.
e. **"Executor" Must Make Election.** If there is a court-appointed executor, that person must make the election. The election may not be made by the surviving spouse if someone else is appointed as the executor. (The regulations do not address the situation of having multiple appointed co-executors. Treas. Reg. § 20.2010-2(a)(6)(i). Presumably the rules for filing estate tax returns would apply, which generally require that all co-executors join in signing the return. *See* Treas. Reg. § 20.6018-2.) If there is no appointed executor (and only if there is no appointed executor), any person in actual or constructive possession of property may file the estate tax return on behalf of the decedent and elect portability (or elect not to have portability apply). *See* IRC § 2203. If a non-appointed executor makes the election, another non-appointed executor (other than a successor to that non-appointed executor) cannot make a contrary election. Treas. Reg. § 20.2010-2(a)(6)(ii). If there is no appointed executor and if the spouse is in actual or constructive possession of property of the decedent, the spouse could file a return first making the portability election, and no other individual would be able to supersede that election with a subsequent return opting out of the election. However, an appointed executor can supersede an election made by a non-appointed executor so long as the appointed executor does so on a timely filed return. Treas. Reg. § 20.2010-2(a)(6). If the appointed executor knows that a return has been filed by a non-appointed executor, a statement to that effect should be attached to the new return which includes a description of the executor's authority to supersede any prior election. Even in an estate that might not otherwise require an appointed executor, one should consider having an executor appointed by a court in order to fix in that person the ability to, and responsibility for, making (or not making) the election. The authors know of no state statute imposing an explicit fiduciary duty on an executor to make a portability election, regardless of whether an estate tax return must otherwise be filed. Any duty imposed would be tricky if multiple non-appointed executors were involved. However, in a case where the surviving spouse was not a beneficiary of his deceased spouse's estate, the Oklahoma Supreme Court has recently imposed a fiduciary duty on a court-appointed executor to file an estate tax return and make the portability election on the theory that the executor owes fiduciary duties to all persons interest in the estate. The court reasoned that because the surviving spouse is the only person who could benefit from the portability election, he was one of those interested persons and the executor had a duty to safeguard the surviving spouse's interest in the DSUE amount. The court fell just short of calling the DSUE amount an estate asset. *Est. of Vose v. Lee*, 390 P3d 238 (Okla. 2017).

**Example 2:** H dies with an IRA payable to his surviving spouse W, along with a brokerage account payable by right of survivorship to his son S. Before any executor is appointed by a local court, W files a timely estate tax return on behalf of H's estate computing his DSUE amount and thereby electing portability. S thereafter files a timely estate tax return electing not to have portability apply. S's election is ineffective. Therefore, E is appointed by a local court to serve as the executor of H's estate. E may file a timely estate tax return electing (or not electing) portability, confirming or superseding the return filed by W.

f. **Computation of DSUE Amount on Return.** As mentioned above, the current Form 706 now includes a section regarding portability, including computation of the DSUE amount. Prior to that time, as long as a complete and properly-prepared estate tax return was filed, it was deemed to include the computation. Estates that filed returns before the updated Form 706 was issued are not required to now file a supplemental estate tax return using the revised form to include the computation. *See* Treas. Reg. § 20.2010-2(a)(7)(i).

g. **Relaxed Requirements for "Complete and Properly-Prepared" Return.** A "complete and properly-prepared" return is generally one that is prepared in accordance with the estate tax return instructions. However, there are relaxed requirements for reporting values of certain assets. For assets that qualify for a marital or charitable deduction, the return does not have to report the values of such assets, but only the description, ownership, and/or beneficiary of the property together with information to establish the right to the deduction. However, the values of assets passing to a spouse or charity must be reported in certain circumstances (where the value relates to determining the amounts passing to other beneficiaries; if only a portion of the property passes to a spouse or charity; if there is a partial disclaimer or partial QTIP election (i.e. an election to qualify the trust as Qualified Terminable Interest Property or "QTIP" for marital deduction purposes); or if the value is needed to determine the estate's eligibility for alternate valuation, special use valuation, or Section 6166 estate tax deferral). Treas. Reg. § 20.2010-2(a)(7)(ii)(A). Therefore, assets passing to a bypass trust are not eligible for the relaxed valuation rules.
In any event, the executor must exercise "due diligence to estimate the fair market value of the gross estate" including property passing to a spouse or charity. The executor must identify the range of values within which the "executor's best estimate" of the gross estate falls. (The temporary regulations advised that until the instructions for the estate tax return were finalized to include those ranges of value, the return had to state the "executor's best estimate, rounded to the nearest $250,000." Temp. Reg. § 20.2010-2T(a)(7)(ii)(B).) The current instructions to IRS Form 706 provide that estimated values be rounded up to the nearest $250,000. See Instructions to Form 706 (revised November, 2016), for decedents dying after December 31, 2015, p. 18.

Observation: The regulations provide little further detail regarding what extent of "due diligence" is required. The Preamble to the Temporary Regulations provided that the inquiry required to determine the executor's best estimate "is the same an executor of any estate must make under current law to determine whether the estate has a filing obligation . . . " TD 9593, IRB 2012-28. Apparently, the required due diligence means something less than obtaining full-blown formal appraisals. In most situations, the executor will need to obtain valuation information in any event to support the amount of any basis adjustment under Section 1014, for purposes of preparing an accurate probate inventory, and perhaps for state estate tax purposes if there is a state estate tax. Various examples are provided in the regulations. Treas. Reg. § 20.2010-2(a)(7)(ii)(C).

Example 3: H's Will provides that his entire estate is to be distributed to a QTIP trust for W. The non-probate assets includible in H's gross estate consist of a life insurance policy payable to H's children from a prior marriage, and H's individual retirement account (IRA) payable to W. H made no taxable gifts during his lifetime. When preparing an estate tax return for H's estate, if the executor makes a QTIP election, attaches a copy of H's Will creating the QTIP, and describes each probate asset and its ownership to establish the estate's entitlement to the marital deduction in accordance with the instructions for the estate tax return and Treasury Regulation Section 20.2056(a)-1(b), then the summary filing requirements outlined in the portability regulations may be used for both the probate estate and for the IRA. However, in the case of the life insurance policy payable to H's children, all of the regular return requirements, including reporting and establishing the fair market value of the policy, apply.

h. A Portability Return is Still an Estate Tax Return. Keep in mind that even if certain valuation requirements are relaxed when a return is filed for purposes of making a portability election, the normal requirements for preparing and filing an estate tax return still need to be observed. Thus, for example, if the executor intends to make a QTIP election (or any other election required to be made on an estate tax return), the QTIP election must be made on the Form 706. (For a discussion of Revenue Procedure 2001-38, Revenue Procedure 2016-49, and their impact on an executor's ability to make a QTIP election in an estate below the filing threshold, see the discussion beginning on page 28 below.)

3. Inclusion in Marital Property Agreements. Because marital property agreements frequently involve persons of unequal wealth, it may be important to address issues related to portability in the agreement. For example, the wealthier spouse may want to be able to use the poorer spouse's DSUE amount. To do so, provisions could be included in the agreement whereby the poorer spouse agrees to commit the executor of his or her estate to prepare the return or provide documents to prepare the return at the wealthier spouse's request while the wealthier spouse bears the cost for the preparation of the return.7 Sample language is attached as Exhibit B.

7 In reviewing a premarital property agreement entered into prior to the enactment of the portability statute and in which the spouses waived "all claims and rights" to each other's property including an intestate share of the other's estate, the Oklahoma Supreme Court confirmed that the waiver did not extend to portability. The court noted that the surviving spouse might have a pecuniary interest in the portability of the DSUE amount. The court also noted that although the spouses had meant their waiver to be comprehensive as to rights that existed at the time of the agreement, portability did not exist at the time of the agreement so the surviving spouse should not be barred from asserting an interest in the DSUE amount now. (What?!?) The executor of the deceased spouse's estate was ordered to prepare and file an estate tax return in order to elect portability, as well as provide the surviving spouse with records needed to prepare the return and a copy of the return for review purposes prior to the filing deadline. See Est. of Vose v. Lee, 390 P3d 238 (Okla. 2017).
F. Portability vs. Bypass Trusts

In our view, portability will be a beneficial "second best" choice for estates of decedents who did no estate tax planning. Bypass trust planning will continue to be the best alternative for most married couples with potentially taxable estates. Although the reasons are discussed in more detail in part IV below, a summary of the main disadvantages is as follows:

1. Need to Elect. Portability works only if the executor of the first deceased spouse files an estate tax return electing to pass the unused exemption to the surviving spouse. IRC § 2010(c)(5). Executors of relatively modest estates may see the cost of filing a complete estate tax return as too high of a price to pay to get only the potential benefit of portability.

2. No Creditor/Divorce/Control Protections. Leaving property to one's spouse in a bypass trust affords a number of non-tax benefits which are not available if no trust is used. In particular, the assets passing to the spouse via a bypass trust: (1) are exempt from attachment by the creditors of the surviving spouse; (2) can't become commingled, and thereby subject to loss in a divorce if the surviving spouse remarries and then divorces; and (3) are assured to pass to the persons designated as beneficiaries by the deceased spouse (unless the surviving spouse is given and exercises a power of appointment over the bypass trust assets).

3. No Shelter of Growth. Assets passing to the bypass trust are exempt from estate tax at the surviving spouse's death regardless of the value of those assets at that time. Thus, a spouse could pass up to $5 million worth of property ($5.49 million in 2017) to a bypass trust, and all of those assets, plus appreciation, would pass to the next generation free of transfer tax. Portability provides the surviving spouse only with the unused exemption amount, unadjusted for inflation or growth. At the same time, keep in mind that although the growth in a bypass trust is sheltered from estate tax at the second death, the assets in the trust will generally not receive a new basis (whether stepped up or down) at the surviving spouse's death.

4. No GST Tax Exemption. Portability applies only to the deceased spouse's estate tax exemption—not to the deceased spouse's GST tax exemption. By proper allocation of the GST exemption to the bypass trust, a married couple can effectively double the amount of property that will avoid estate taxation upon the death of their children. This doubling is lost if a bypass trust is forgone in favor of portability.

5. Possible Loss upon Remarriage. The surviving spouse is entitled to use the unused estate tax exemption only of the most recently deceased spouse. IRC § 2010(c)(4)(B)(i). If the surviving spouse remarries, and the new spouse then dies, that spouse (who may have a substantial estate, or for whose estate an estate tax return is not filed to port any unused exemption), becomes the most recently deceased spouse. Unless the surviving spouse makes large taxable gifts before the new spouse's death, any unused exemption of the first spouse to die is then lost.

G. Use with Bypass Trusts—It's Not "Either/Or"

Don't forget that bypass trust planning and portability are not "either/or" propositions. Even if the decedent's will or revocable trust includes a bypass trust, the executor should consider whether to make a portability election. If the estate of the first spouse is not large enough to use his or her full exemption amount, if the bypass trust is not fully funded, or if for any other reason there is any "excess" exemption, it may be smart to elect portability in addition to utilizing a bypass trust.

Example 4: H dies in 2011 with an estate of $4 million which passes to a bypass trust for W. A portability election is made passing H's remaining $1 million DSUE amount to W, who has her own $4 million estate.

During the next nine years, W's estate grows at 6% per year, while inflation is only 3% per year. W dies at the end of 9 years. At that time, her estate has grown to about $6.75 million, while her basic exclusion has grown to only about $6.5 million. If no portability election had been made, her estate would owe about $100,000 in tax. But since the portability election was made, W's estate may utilize not only her $6.5 million (inflation-adjusted) basic exclusion amount, but also the $1 million DSUE amount from H's estate, thereby eliminating the estate tax.

H. Estate Administration Musts

When no estate tax planning is included in a decedent's will, in cases of intestacy, or in any situation in which some of the decedent's exemption amount won't be used, estate administration counsel advising with regard to estates of persons dying with a surviving spouse will need to document their conversations about the potential availability of portability. Deciding not to go to the trouble and expense of electing portability may be a perfectly rational decision in many cases. But all too often the decision is judged with hindsight. If the surviving spouse dies owing estate tax, and if that tax could have been reduced or eliminated by electing portability, the personal representative and his or her advisors may be second-guessed. We recommend communicating the issues involved to the personal representative in writing, and documenting the personal representative's decision. Ideally, having the next generation sign off on the decision now would be helpful. Your discussions, and perhaps more importantly, your records of these discussions, may help to minimize criticism about the personal representative's decision about the election. A sample letter that might be used to outline the issues for an executor is attached as Exhibit C to this paper.

III. WHAT IS BASIS?

Basis is a fundamental concept in income tax planning. A taxpayer may incur a tax liability whenever he or she sells assets at a gain. Gain is measured by the excess of the amount realized from a disposition of property over the taxpayer's adjusted basis in that property. IRC § 1001. Basis also establishes the amount upon which depreciation deductions are based. IRC § 167(c). In general, a taxpayer's basis in an asset is measured by its cost, with certain adjustments. IRC §§ 1012, 1016. However, a special rule applies when the property in question is acquired from a decedent. IRC § 1014(a). Because of this special rule, in estate planning, increased applicable income tax rates have brought a new focus on the importance of income tax planning, giving rise to a new emphasis on potentially maximizing a taxpayer's basis in property acquired from a decedent.

A. Basis in Property Acquired from a Decedent

With a few exceptions, the basis of property in the hands of a person acquiring the property from a decedent, or to whom the property passed from a decedent, is equal to: (i) the fair market value of the property at the date of the decedent's death; (ii) if an "alternate valuation date" election is validly made by the executor of the decedent's estate, its value at the applicable valuation date prescribed by Section 2032 of the Internal Revenue Code (the "Code"); and (iii) if a "special use valuation" election is validly made by the executor of the decedent's estate, its value for special use valuation purposes prescribed by Code Section 2032A. IRC § 1041(a). In short, then, in most cases, the basis in property inherited from a decedent is the value of that property for federal estate tax purposes. Although often called a "step-up" in basis, the basis in various assets may be stepped up or down. Therefore, it is more accurate to call it a basis adjustment. Original basis is simply ignored and federal estate tax values are substituted. The adjustment to the basis of a decedent's assets occurs regardless of whether an estate tax return is filed, and regardless of whether the estate is even large enough to be subject to federal estate tax.

1. Basis Consistency. Although the basis adjustment occurs regardless of whether an estate tax return is filed, Code Section 1014(f), enacted on July 31, 2015 as part of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (P.L. 114-41) ("Transportation Act"), provides that basis of certain property acquired from a decedent, as determined under Code Section 1014, may not exceed the value of that property as finally determined for federal estate tax purposes, or if not finally determined, the value of that property as reported on a statement made under Code Section 6035. Code Section 6035, also enacted as part of the Transportation Act, provides that the executor of any estate that is required to file an estate tax return under Code Section 6018 (i.e., an estate that exceeds the estate tax filing threshold) must furnish to the IRS and to each person acquiring any interest in property included in the decedent's
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gross estate for federal estate tax purposes a statement identifying (1) the value of each interest in that property as reported on the estate tax return, and (2) any other information that the IRS might require. IRC § 6035(a)(1). Note that the reporting requirement is limited to the value of the property as finally determined for estate tax purposes; it is not a requirement to report basis of the property in the hands of the distributee. In addition, each person required to file a return under Code Section 6018(b) (persons other than executors holding estate property) must furnish to the IRS and to each other person who holds a legal or beneficial interest in the property to which that return relates a statement identifying the information described above. IRC § 6035(a)(2). The IRS is required to prescribe any regulations that are necessary to carry out these rules, including rules applicable to estates for which no estate tax return is required to be filed, and for situations where a surviving joint tenant or other recipient might have better information than the executor regarding the basis or fair market value of the property. IRC § 6035(b). In January 2016, the IRS issued Form 8971 ("Information Regarding Beneficiaries Acquiring Property from a Decedent") to be used to provide the required information to the IRS, and Schedule A to Form 8971 to provide the required information to beneficiaries. Updated instructions to Form 8971 and Schedule A were released in September 2016. On March 4, 2016, the IRS issued proposed and Temporary Regulations under Code Sections 1014(f) and 6035. See TD 9757. Pursuant to the proposed regulations, Form 8971 is termed an Information Return, and Schedule A is termed a Statement. Prop. Treas. Reg. § 1.6035-1(g).

Suffice it to say, many questions remain unanswered by the proposed regulations, and comments will be provided to the IRS and Treasury Department with the hope of clarifying various provisions. Comments to the proposed regulations were invited and groups, such as The American College of Trust and Estate Counsel ("ACTEC") and the American Institute of Certified Public Accountants ("AICPA") submitted comments.

We do know that if a federal estate tax return is required to be filed pursuant to Code Section 6018, the executor must report certain information to the IRS, and must provide certain information to each beneficiary of the property, including a description of the property and its value. Prop. Treas. Reg. § 1.6035-1(a), (b), (c). In identifying the beneficiaries to whom the information is to be provided, if a beneficiary is a trust, the information is furnished to the trustee. Prop. Treas. Reg. § 1.6035-1(c)(2). In the case of an estate where the property passing to a beneficiary has not been identified by the due date for reporting, such as when funding decisions have not been made, the executor must provide information regarding all property that may be used to fund the beneficiary's interest to each beneficiary that may be affected, and must provide the information to all potential beneficiaries of the property. Prop. Treas. Reg. § 1.6035-1(c)(3). Once this information is given, no further reporting is required. Id.

We also know that Form 8971 and Schedule A must be furnished no later than the earlier of (1) 30 days after the date on which the estate tax return is required to be filed (including extensions), or (2) 30 days after the date the estate tax return is filed. IRC § 6035(a)(3)(A); Prop. Treas. Reg. § 1.6035-1(d)(1). In addition, IRS Notice 2016-27, 2016-15 IRB 1, published on March 24, 2016 provides that for any reporting due before June 30, 2016, reporting was not required until June 30, 2016.9 Final Treasury Regulation § 1.6035-2 was issued on December 2, 2016 confirming that the first required reporting was on June 30, 2016. See TD 9797. The proposed regulations confirm that the value as finally determined for federal estate tax purposes serves as the beneficiary's initial basis in the property and the beneficiary's basis is capped by the estate tax value (i.e., basis consistency), although post-death events may cause adjustments to the property's basis. Prop. Treas. Reg. § 1.1014-10(a), (c).

Although property that qualifies for the marital or charitable deduction is excluded from the basis consistency rules of Code Section 1014(f), that property is not excluded from the reporting requirements of Code Section 6035. Prop. Treas. Reg. §§ 1.1014-10(b)(2), 1.6035-1(b). Certain property is excluded from the reporting requirements of Code Section 6035, however, including cash (other than collectible cash),

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9 This Notice was the third extension of the due date for the first reporting required pursuant to IRC § 6035. Although the first due date was August 30, 2015, Notice 2015-57 was issued on August 21, 2015, extending the due date for the first reporting to February 29, 2016, and then Temporary Treasury Regulation § 1.6035-2T was issued providing a transitional rule extending the due date for the first reporting to March 31, 2016. Twenty days after the regulation was published, Notice 2016-27 was issued.
income in respect of a decedent (IRD), certain tangible personal property, and property sold or otherwise disposed of (and thus not distributed to a beneficiary) by the estate in a manner in which capital gain or loss is recognized.\textsuperscript{10} Prop. Treas. Reg. § 1.6035-1(b). In addition, if an estate is below the filing threshold for federal estate tax purposes but the return is filed for another reason, such as to make a portability election, the executor is not subject to the reporting requirements of Code Section 6035. Prop. Treas. Reg. §1.6035-1(a)(2).

One of the more surprising (and shocking) provisions in the proposed regulations has to do with property that is later-discovered or was otherwise omitted from a federal estate tax return. If a federal estate tax return was never filed and after-discovered or omitted property is discovered that would generate or increase estate taxes, the basis in that property is zero until the federal estate tax value is determined. Prop. Treas. Reg. § 1.1014-10(c)(3)(ii). In contrast, if a federal estate tax return is filed and additional property is discovered, as long as the executor includes the property on an estate tax return prior to the expiration of the statute of limitations on assessment, the final value (and therefore, the beneficiary's initial basis) in the property will be the federal estate tax value of the property. However, if the limitations period has expired, the basis in the after-discovered or omitted property is deemed to be zero, with no recourse. Prop. Treas. Reg. § 1.1014-10(c)(3)(i).

If there is an adjustment to the information required to be filed with the IRS or reported to a beneficiary that would cause the reported information to be incorrect or incomplete, a supplemental statement must be filed no later than the date 30 days after the adjustment is made. IRC § 6035(a)(3)(B); Prop. Treas. Reg. § 1.6035-1(e)(1), (2), (4). An adjustment includes a situation in which a beneficiary different than who previously received Schedule A receives property identified on the Schedule A, such as because of a disclaimer or because of a value change as a result of audit. Supplemental reporting is not required, however, if reporting of the same asset was made to multiple beneficiaries because a funding decision had not been made at the time of the initial reporting. \textit{Id.}

Another surprising provision in the proposed regulations is the requirement to report subsequent transfers. The proposed regulations provide that for property reported pursuant to Code Section 6035, if that property is subsequently transferred to a related transferee and the transferee determines its basis, in whole or part, by reference to the transferor's basis, the transferor must file a supplemental Schedule A with the IRS and provide a copy to the transferee within 30 days of the transfer. A related transferee is defined to include a member of a transferor's family as defined in Code Section 2704(c)(2), an entity controlled by the transferor or the transferor's family as defined in Code Section 2701(b)(2)(A), and a trust of which the transferor is the deemed owner for income tax purposes. Prop. Treas. Reg. § 1.6035-1(f). Presumably, the requirement for reporting subsequent transfers extends indefinitely.

2. \textbf{Holding Period.} A person acquiring property from a decedent whose basis is determined under Code Section 1014 is considered as being held by the person for more than one year. IRC § 1223(9). Therefore, any post-death gains will be treated as long-term capital gain, even if the property is sold within one year of the decedent's death.

B. \textbf{What Property is "Acquired from a Decedent"?}

Most people think of property "acquired from a decedent" as simply property passing to them under the will of a deceased person. For purposes of determining basis, however, the Code lists ten separate methods by which property can be acquired from a decedent. Some of the listed methods contain effective dates that have since passed, which make parsing the statute somewhat difficult. In summary, the current applicable list includes the following seven items:

1. \textbf{Inherited Property.} Property acquired by bequest, devise, or inheritance. The statute makes clear that the basis adjustment applies not only to beneficiaries, but also to the decedent's property held by his or her estate. IRC § 1014(b)(1).
2. **Revocable Trust Property.** Property transferred by the decedent during his lifetime and placed in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust. IRC § 1014(b)(2).

3. **Property with Retained Right to Control Beneficial Enjoyment.** Property transferred by the decedent during his lifetime and placed in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust. IRC § 1014(b)(3).

4. **Property Subject to a General Power of Appointment.** Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will. IRC § 1014(b)(4).

5. **Both halves of Community Property.** Property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any state, or possession of the United States, or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate for federal estate tax purposes. Thus, unlike the surviving spouse's separate property, both halves of a couple's community property receive a new cost basis upon the death of either spouse. IRC § 1014(b)(6).

6. **Other Property Includable in the Decedent's Gross Estate.** 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 for estate tax purposes. IRC § 1014(b)(9). Clearly, the provision applying a basis adjustment for property "included in determining the value of the decedent's gross estate" overlaps with several other provisions. Revocable trust property, property with a retained right to control beneficial enjoyment, property passing pursuant to the exercise of a power of appointment, and QTIP property are all included in determining the value of the decedent's gross estate. But this catch-all provision of Section 1014(b)(9) alone is subject to a curious limitation. As discussed below, any basis adjustment allowed solely by reason of Section 1014(b)(9) is reduced by "the amount allowed to the taxpayer as deductions . . . for exhaustion, wear and tear, obsolescence, amortization and depletion on such property before the death of the decedent."

7. **QTIP Property.** Property includible in the gross estate of the decedent under Code Section 2044 (relating to property for which a "QTIP" marital deduction was previously allowed). IRC § 1014(b)(10).

C. **Exceptions**

Not all property acquired from a decedent receives a new cost basis at death.

1. **Assets Representing Income in Respect of a Decedent.** Most notably, items which constitute a right to income in respect of a decedent ("IRD") under Code Section 691 do not receive a new cost basis. Generally, IRD is comprised of items that would have been taxable income to the decedent if he or she had lived, but because of the decedent's death and income tax reporting method, are not reportable as income on the decedent's final income tax return. Examples of IRD include accrued interest, dividends declared but not payable, unrecognized gain on installment obligations, bonuses and other compensation or commissions paid or payable following the decedent's death, and amounts in IRAs and qualified benefit plans upon which the decedent has not been taxed. Note this means that Roth IRAs and nonqualified contributions to retirement plans are not IRD. A helpful test for determining whether an estate must treat an asset as IRD is set forth in Estate of Peterson v. Commissioner, 667 F2d 675 (8th Cir. 1981): (i) the decedent must have entered into a "legally significant transaction"—not just an expectancy; (ii) the decedent must have performed the substantive tasks required of him or her as a precondition to the transaction; (iii) there must not exist any economically material contingencies which might disrupt the transaction; and (iv) the decedent would have received the income resulting from the transaction if he or she had lived. The basis in an IRD asset is equal to its basis in the hands of the decedent. IRC § 1014(c).
This rule is necessary to prevent recipients of IRD from avoiding federal income tax with respect to items in which the income receivable by a decedent was being measured against his or her basis in the asset (such as gain being reported on the installment basis).

2. **Property Inherited Within One Year of Death.** A special exception is provided for appreciated property given to a decedent within one year of death, which passes from the decedent back to the donor or the donor's spouse as a result of the decedent's death. IRC § 1014(e). This rule is designed to prevent taxpayers from transferring property to dying individuals, only to have the property bequeathed back to them with a new cost basis.

3. **Depreciable Property Owned by Others.** As noted above, if a basis adjustment arises solely from the application of Section 1014(b)(9), the basis adjustment is reduced by the amount allowed "to the taxpayer" for depreciation, amortization, or depletion prior to the decedent's death. IRC § 1014(b)(9). This limitation apparently applies only when someone other than the decedent owns depreciable, amortizable or depletable property which is nevertheless includible in the decedent's taxable estate. The Treasury Regulation interpreting the provision is entitled, "Special rule for adjustment to basis when property is acquired from a decedent prior to his death." It appears to have originated at a time when assets given away within three years of death were taxed to the decedent under a prior version of Code Section 2035. See Treas. Reg. § 1.1014-6(a)(3) Ex. 1. Its application is not, however, limited to that situation. Thus, for example, the provision has been applied to depreciable property held by the decedent and another as joint tenants with rights of survivorship. See Treas. Reg. § 1.1014-6(a)(1). It has also been applied to property held by spouses as tenants by the entirety. Rev. Rul. 58-130, 1958-1 CB 121. If an owner of the property was able to claim a deduction for depreciation, amortization or depletion during the decedent's lifetime, this provision prevents the owner from recouping that deduction as a result of having the property included in another person's estate. Thus, for example, assume that A made a gift of depreciable property with a basis of $50,000 to B, and retained a life estate. Prior to A's death, B claimed depreciation deductions of $20,000. When A dies, the property, valued at $80,000, is included in determining the value of A's gross estate under Section 2036(a)(1). Pursuant to Section 1014(b)(9), B's adjusted basis in the property as of the date of the decedent's death is $60,000 ($80,000, the fair market value at the decedent's death, less $20,000, the total depreciation deduction actually allowed to B). See Treas. Reg. § 1.1014-6(c).

4. **Property Subject to a Conservation Easement.** Property that is the subject of a conservation easement is entitled to special treatment for estate tax purposes. In general, if the executor so elects, the value of certain conservation easement property may be excluded from the value of the decedent's estate under Code Section 2031(c), subject to certain limitations. To the extent of the exclusion, the property retains its basis in the hands of the decedent. IRC § 1014(a)(4).

IV. **A NEW ESTATE PLANNING PARADIGM**

Traditionally, estate planners have recommended that their clients incorporate a variety of techniques into their estate plans which were designed to avoid, defer, or minimize the estate tax payable when property passed from one taxpayer to another. These strategies have often involved the use of one or more trusts which were aimed at minimizing transfer taxes. A corollary effect of many of these techniques was that income taxes payable might be increased in some cases, but when estate and gift tax rates exceeded 50%, and capital gain rates were only 15%, the income tax "cost" associated with many common estate planning tools seemed worthwhile. Under the current tax regime, higher estate tax exemptions and the availability of portability mean that many clients are no longer subject to estate or gift taxes, regardless of whether the estate planning strategies recommended in the past are employed. At the same time, the income tax cost of these strategies has increased, due to the enactment of higher federal income tax rates and the adoption of the 3.8% tax on net investment income. In short, common strategies previously employed to save estate tax may now fail to reduce estate taxes owed, and may instead increase income tax exposure.

A. **Using Bypass Trusts**

1. **No Basis Adjustment at Second Death.** For years, estate planners have designed bypass trusts with the express goal of excluding those assets from the taxable estate of the surviving spouse for estate tax purposes. While estate taxes were avoided, so too was a cost basis adjustment in those assets
upon the death of the surviving spouse. For many clients, bypass trusts are still important to help achieve a number of non-tax goals, which are discussed at IV.B, below. For clients with estates subject to the estate tax, these trusts often have the felicitous effect of lowering overall taxes for the family as well.11 With fewer estates subject to estate tax, however, achieving the clients' non-tax objectives may come at the price of higher overall taxes.

Example 5: H and W have a community property estate of $6 million (or simply two relatively equal estates totaling $6 million). H dies with a Will that creates a traditional bypass trust for W. W outlives H by 10 years. Over that time, the trustee distributes all of the bypass trust's income to W, but the fair market value of the trust's assets has doubled to $6 million. Meanwhile, W has retained her own $3 million in assets, which have held their value at $3 million. At the time of W's death, no estate tax will be due on her $3 million estate. The assets in the bypass trust will not be included in her estate for federal estate tax purposes, so they will not receive a new cost basis at the time of her death. As a result, H and W's children will inherit assets in the bypass trust with a value of $6 million, but with a basis of only $3 million. If instead, H had left the property outright to W, and if H's executor had filed an estate tax return electing portability, no estate tax would be owed on W's $9 million estate. Had H left his assets to W outright (or to a differently designed trust), the children would have received a new cost basis of $6 million in the assets passing from H to W, potentially saving them $714,000 in taxes ($3,000,000 x 23.8%).12

2. Higher Ongoing Income Tax Rates. Single individuals are subject to the highest income tax rates on income in excess of $400,000 ($418,400 in 2017), and are subject to the tax on net investment income if their income exceeds $200,000. IRC §§ 1, 1411. In contrast, income not distributed from a trust is taxed at the top income tax rate to the extent it exceeds $12,500 (for 2017), and is subject to the net investment income tax if its undistributed net investment income exceeds that amount. Id. Therefore, under the foregoing example, unless the wife's taxable income would otherwise exceed $418,400 ($470,700 if she remarries and files jointly), any taxable income accumulated in the bypass trust will be taxed at a higher income tax rate than it would if no trust had been used. Including the tax on undistributed net investment income, the trust's federal income tax rate might be 43.4% for short term capital gains and ordinary income and 23.8% for long term capital gains and qualified dividends. Contrast these rates to rates of only 28% for ordinary income and 15% for capital gains if the wife remains single and her taxable income were between $91,900 and $191,650 (or between $153,100 and $233,350 if she remarries), all using 2017 income tax brackets. IRC § 1.

3. Some Assets Cause Greater Tax Burdens. A client's asset mix may impact the importance of these tax issues. For example, assets such as IRAs, qualified plans, and deferred compensation, may give rise to ordinary income taxes, without regard to their basis, other than distributions that qualify as the owner or other recipient's "investment in the contract" as that term is defined for these assets. Retirement plan assets left outright to a spouse are eligible to be rolled over into the spouse's name, which may make them eligible for a more favorable income tax deferral schedule than if they passed into a bypass or other trust. A personal residence may be eligible to have all or a portion of any capital gains tax recognized on its sale excluded from income if owned outright. IRC § 121(a). The exclusion is not available to the extent that the residence is owned by a non-grantor trust. See TAM 200104005. Some types of business entities (notably, S corporations) require special provisions in the trust to ensure that they are eligible to be treated as "Qualified Subchapter S Trusts" or "Electing Small Business Trusts." If these provisions are omitted or overlooked during the administration of the trust, substantially higher taxes may

11 Although beyond the scope of this paper, in states where a state income tax applies, those additional taxes must also be considered.

12 Of course, an outright bequest would have a much worse tax result if the wife had remarried and her second husband had died leaving her no DSUE amount, or if H's property had declined in value, thereby causing a step-down in basis.

13 IRC § 1. In the last quarter of each year, the IRS issues a Revenue Procedure that provide the inflation-adjusted numbers for a variety of items. Revenue Procedure 2016-55, 2016-45 IRB 707 was issued on October 25, 2016 and provides the tax rate tables for taxpayers for the year 2017.
result to all shareholders of the entity. For assets that the family has no intention of selling or depreciating (such as a family vacation home), a basis adjustment may be unimportant. Similarly, with regard to an investment account that is actively traded, capital gains and losses may be recognized as a result of frequent trades, and the basis in the investments at the time of the surviving spouse's death may very nearly equal the fair market value of those investments at that time, making a basis adjustment less important.

Example 6: H has an IRA worth $1 million which earns 6% per year, the beneficiary of which is the trustee of a bypass trust for his wife W. H dies when W is 60 years old, and W is not the sole beneficiary of the trust. Because the IRA is payable to the trust, W cannot roll the IRA over into her own IRA. Instead, she must begin to take minimum required distributions in the year following H's death, based upon her single life expectancy. IRC § 408(d)(3)(C); Treas. Reg. §§ 1.401(a)(9)-5, A-5(a), A-5(c)(1), A-7(c)(3), Ex. 1(iii). If instead, the IRA had been payable to W, she could have rolled the IRA over into her own IRA, deferred minimum required distributions until age 70 ½, and used the more favorable unified table for her life expectancy. IRC §§ 401(a)(9)(A), 402(a)(7), 402(c)(9), 408(d)(3); Treas. Reg. § 1.408-8, A-5(a), A-7. If W lives to age 90 taking only minimum required distributions, then in either event, W would receive about $1.4 million after tax from the IRA. If the IRA was payable to the bypass trust, it would then hold about $2.75 million. If instead, the IRA had been payable to W, her ability to defer distributions for an additional 10 years would mean that the IRA would hold nearly $4 million!

4. Disclaimer Bypass Trusts. Married couples can structure their wills or revocable trusts to allow the surviving spouse to take a "second look" at their financial and tax picture when the first spouse dies. If the total combined estates will be less than the applicable exclusion amount (including any DSUE amount) then the survivor can accept an outright bequest of assets, and if desired, the executor can file an estate tax return making the portability election. If the total value of the estate is expected to exceed the applicable exclusion amount, then the surviving spouse can disclaim all or any part of the inheritance. Language in the will or revocable trust could provide that the disclaimed amount passes into the bypass trust. In order for the disclaimer to be effective, it must comply with the technical requirements of local law and the Code. See, e.g., TEX. PROP. CODE Chpt. 240; IRC § 2518. The disclaimer must be filed within nine months of the date of death and before any benefits of the disclaimed property are accepted in order to be valid under federal law. The disclaimed property must generally pass in a manner so that the disclaiming party will not benefit from the property. An important exception to this rule, however, permits the surviving spouse to disclaim property and still be a beneficiary of a trust, including a bypass trust, to which the disclaimed property passes. IRC § 2518(b)(4)(A). More troubling is the requirement that the disclaimed property must pass without direction or control of the disclaiming party. This requirement generally prevents (or at least greatly restricts) the surviving spouse from retaining a testamentary power of appointment over the bypass trust to which assets pass by disclaimer. See Treas. Reg. § 25.2518-2(e)(1)(i); Treas. Reg. § 25.2518-2(e)(5), Exs. (4), (5).

B. Advantages of Trusts over Outright Bequests

With the advent of "permanent" high estate tax exemptions and portability, estate planners and their clients concerned about the foregoing issues, or simply seeking "simplicity," may conclude that using trusts in estate planning is no longer warranted. But tax issues are only one part of the equation. In many respects, outright bequests are not nearly as advantageous as bequests made to a trust. In an ideal world, the estate plan would be designed to capture all of the benefits of trusts, without the tax downsides. Why might someone choose to make a bequest in trust instead of outright, despite the potential tax costs?

1. Control of Assets. A trust allows the grantor to better ensure that the assets are managed and distributed in accordance with his or her wishes. Many clients express confidence that their spouses will not disinherit their family, but they still fear that a second spouse, an unscrupulous caregiver, or other unforeseen person or event may influence the surviving spouse to change the estate plan in ways that they do not intend. Placing property into trust allows the grantor to control to a large degree how much (if at all) the surviving spouse can alter the estate plan. The grantor can name a trustee other than the spouse if

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desired. In addition, even if the surviving spouse is the trustee, if he or she later becomes incapacitated, a successor trustee can manage the trust assets, thereby avoiding the need for a guardian or other type of court-appointed conservator.

2. **Creditor Protection.** If an inheritance passes outright and free of trust, the property will be subject to attachment by outside creditors unless the property is otherwise exempt from attachment under local law (in Texas, for example, exempt assets might include a homestead or an interest in a retirement plan). Assets inherited in trust are generally protected from creditors so long as the trust includes a valid "spendthrift" clause. See, e.g., TEX. PROP. CODE § 112.035. State law greatly controls the extent of these protections.\(^{15}\)

3. **Divorce Protection.** Inherited assets constitute separate property of the recipient, which provides some measure of divorce protection. See, e.g., TEX. FAM. CODE § 7.002. However, in Texas, if those assets are commingled, the community property presumption may subject them to the claims of a spouse upon divorce. See TEX. FAM. CODE § 3.003. Similar laws regarding marital property may apply even in non-community property states. If the assets pass in trust, however, the trustee's ownership of the trust assets helps ensure that they will not be commingled. In addition, the same spendthrift provisions that protect trust assets from other creditors may protect them from claims of a prior spouse. Again, state law may place limits on this protection as in Texas, where spendthrift provisions do not prevent trust assets from being used to pay child support claims. See, e.g., TEX. FAM. CODE § 154.005.\(^{16}\)

4. **Protection of Governmental Benefits.** If the surviving spouse is eligible (or may become eligible) for needs-based government benefits (e.g. Medicaid), a bypass or other trust may be structured to accommodate eligibility planning. An outright bequest to the spouse may prevent the surviving spouse from claiming those benefits. However, a testamentary bypass trust with appropriate spendthrift provisions will generally not be considered to be a resource of the surviving spouse for purposes of determining eligibility for Medicaid. See SSA Program Operations Manual System § 01120.200.D.2.

5. **Protection from State Inheritance Taxes.** Assets left outright may be included in the beneficiary's taxable estate for purposes of state estate or inheritance tax. While the inheritance tax in many states has been repealed or is inoperable so long as there is no federal estate tax credit for state death taxes paid, there can be no assurance that the beneficiary will reside (or remain) in one of those states. Currently, 18 states and the District of Columbia impose a separate stand-alone estate or inheritance tax.\(^{17}\) The potential exposure depends upon the exemptions and rates applicable at the time of the beneficiary's death, but the applicable taxes can be surprisingly high. See, e.g., Minn. Stat. § 291-03 (2013) (imposing a state estate tax on 2017 estates exceeding $1.8 million in value).

6. **Income Shifting.** If permitted, income earned by a trust can be distributed to trust beneficiaries who may be in lower income tax brackets than the surviving spouse or the trust. IRC §§ 651, 661. Income from assets left outright cannot be "sprinkled" or "sprayed" to beneficiaries in lower tax brackets. For many families, a trust's ability to shift income may lower the overall family income tax bill.

7. **Shifting Wealth to Other Family Members.** While a surviving spouse might make gifts of his or her assets to children, elderly parents, or other family members, those gifts use up the spouse's gift

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\(^{15}\) For an example of a recent case where an appellate court upheld a trial court decision allowing a third-party settled, discretionary, spendthrift trust to be part of the property divisible in a divorce proceeding, see the very fact-driven decision in *Pfannenstiehl v. Pfannenstiehl*, 37 NE3d 15 (Mass. App. 2015). On August 4, 2016, the Massachusetts Supreme Judicial Court overturned the trial court decision (and thereby the Appeals Court as well) in *Pfannenstiehl v. Pfannenstiehl*, 475 Mass. 105, 2016 WL 4131248 (Mass. 2016).

\(^{16}\) See *Pfannenstiehl*, fn. 15 for an even broader example of trust assets being considered by a Massachusetts court in a divorce proceeding.

\(^{17}\) The states that impose an estate or inheritance tax at death are Connecticut, Delaware, District of Columbia, Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey (although its estate tax is repealed as of 1/1/2018, its inheritance tax is not), New York, Oregon, Pennsylvania, Rhode Island, Vermont and Washington. See the ACTEC State Survey, Fox, *State Death Tax Chart*, available at [http://www.actec.org/resources/state-death-tax-chart/](http://www.actec.org/resources/state-death-tax-chart/) (last revised January 28, 2017).
and estate tax exemption to the extent that they exceed the gift tax annual exclusion amount. If assets are held in a bypass trust, and if the trust permits distributions to other family members, the amounts distributed to them are not treated as gifts by the surviving spouse, and do not use any of the spouse's gift or estate tax exemption or annual exclusion, regardless of the amount of the distributions.

8. No Inflation Adjustment. The DSUE amount, once set, is not indexed for inflation, whereas the surviving spouse's basic exclusion amount (the $5 million base) is adjusted beginning in 2012 for inflation after 2010 (being $5.45 million in 2016 and $5.49 million in 2017). In addition, if assets are inherited in a bypass trust, any increase in the value of those assets remains outside the surviving spouse's estate. The importance of this feature increases: (i) as the value of a couple's net worth approaches $10 million; (ii) if asset values are expected to increase rapidly; and (iii) if the surviving spouse may be expected to outlive the decedent by many years.

Example 7: H dies in 2011 with a $4 million estate. His Will leaves everything to W, and a portability election is made. W has her own estate, also worth $4 million. During the next nine years, the estate grows at 6% per year, while inflation is only 3% per year. W dies at the end of 9 years. At that time, her estate (plus the amount she inherited from H) has grown to about $13.5 million, while her basic exclusion amount has grown to only about $6.5 million. When combined with the $5 million DSUE amount received from H, her applicable exclusion amount is $11.5 million, resulting in federal estate taxes of about $800,000. If instead, H's $4 million estate had passed into a bypass trust for W, W's basic exclusion amount of $6.5 million plus her DSUE amount of $1 million would exceed her $6.75 million estate. Instead of paying $800,000 in estate tax, no estate tax would be due on her estate, and no estate tax would be paid on the $6.75 million owned by the bypass trust.

9. Risk of Loss of DSUE Amount. As mentioned above, the surviving spouse is entitled to use the unused estate tax exemption only of the most recently deceased spouse. IRC § 2010(c)(4)(B)(i). If the surviving spouse remarries, and the new spouse then dies, the new spouse (who may have a substantial estate, or for whose estate an estate tax return may not be filed to pass along any DSUE amount), becomes the last deceased spouse. Unless the surviving spouse makes taxable gifts before the new spouse's death (thereby using the DSUE amount of the first deceased spouse), any unused exemption of the first spouse to die is then lost. If no DSUE amount is acquired from the new last deceased spouse, the cost to the family could be $2.196 million or more in additional estate tax (40% of $5.49 million). This risk does not apply if assets are inherited in a bypass trust.

Example 8: W1 dies in 2011, leaving her entire estate to H, and a portability election is made with regard to W1's estate on a timely filed estate tax return. H marries W2 in 2014. W2 dies in 2017 leaving her sizable estate to the children of her first marriage. As a result, no DSUE amount is available to H with regard to W2's estate. Since W2 is now H's "last deceased spouse," H has no DSUE amount. The DSUE amount formerly available from W1 is lost.

10. No DSUE Amount for GST Tax Purposes. There is no "portability" of the GST tax exemption. In 2017, a couple using a bypass trust can exempt $10.98 million or more from both estate and GST tax, if not forever then at least a long as the Rule Against Perpetuities allows. A couple relying only on portability can only utilize the GST tax exemption of the surviving spouse ($5.49 million in 2017).

Example 9: Assume the same facts as in Example 5. If portability is used, only $12.7 million after tax ($13.5 million less $800,000 in estate tax) is left to pass to trusts for children. W may shelter only $6.5 million of that amount from GST tax, since only her (inflation-adjusted) GST tax exemption is available to allocate to the children's trusts. The balance ($6.2 million) will not be exempt from GST tax, and will likely be taxed in the estate of the children. If instead, H's estate had passed into a bypass trust, H's GST exemption could have been allocated to the bypass trust, and the exemption would have continued on in trusts for children. In addition, W could allocate her GST tax exemption to shelter almost all of her $6.75 million after-tax estate. Not only would the children inherit $800,000 more, but virtually all of the inheritance could pass to them in GST tax-exempt trusts.

Efficient use of a couple's GST tax exemption may be more important if the couple has fewer children among whom to divide the estate, especially when those children are successful in their own right.
Example 10: H and W, a married couple with a $10 million estate, both die in 2011 leaving everything outright to their only child C. As a result, C immediately has a taxable estate. If instead, after leaving everything to each other (using portability), the survivor leaves assets to a lifetime trust for C, only about half of the estate can pass into a GST tax-exempt trust, using the surviving spouse's GST tax exemption. The balance will pass into a non-exempt trust for C (usually with a general power of appointment), which can lead to an additional $5 million (plus growth) added to C’s estate. If the first spouse’s estate had passed into a bypass trust (or, as discussed below, into a QTIP trust for which a “reverse” QTIP election was made for GST tax purposes), the entire $10 million could pass into a GST tax-exempt trust for C, completely avoiding estate and GST tax at the time of C’s death.

11. Must File Estate Tax Return for Portability. In order to take advantage of the DSUE amount, the executor of the deceased spouse’s estate must file a timely and complete estate tax return. Once the last timely estate tax return is filed, any election regarding portability is irrevocable. If there is no appointed executor, the regulations provide that persons in possession of the decedent's assets (whether one or more) are the "executor" for this purpose. If those persons cannot agree upon whether to make the portability election, a probate proceeding may be advisable, simply to appoint an executor.

12. Impact on Life Insurance Planning. Clients who choose to utilize portability planning rather than implementing more traditional bypass trust planning should consider the use of life insurance, and especially insurance owned by younger-generation family members or by an irrevocable life insurance trust (discussed in detail below) as a “hedge” against some of the shortcomings that may arise by counting on the use of the DSUE amount. For example, life insurance can make up for (or at least provide liquidity for the payment of) estate, inheritance, or GST taxes that might result from the (i) lack of an inflation adjustment for the DSUE amount; (ii) loss of the DSUE amount as a result of re-marriage and subsequent death of the surviving spouse; and (iii) lack of a DSUE amount for GST tax purposes. Life insurance owned by an irrevocable trust may substitute in whole or in part for the loss of control that results from forgoing bypass trust planning. That is, the irrevocable nature of such a trust allows the insured spouse to name beneficiaries other than the surviving spouse and may ensure that the surviving spouse cannot divert assets away from those beneficiaries. In addition, at least in Texas, creditors cannot generally attach the cash value of a life insurance policy, so having the surviving spouse invest in a life insurance policy may provide creditor protection benefits that are missed if a bypass trust is forgone.

C. Using QTIPable Trusts

Placing property into a trust eligible for the estate tax marital deduction offers many of the same non-tax benefits as bypass trusts but without many of the tax detriments.

1. Control, Creditor, and Divorce Protections. Like a bypass trust, a QTIP trust offers creditor and divorce protection for the surviving spouse, potential management assistance through the use of a trustee or co-trustee other than the spouse, and control over the ultimate disposition of assets for the transferor.

2. Less Income Tax Exposure. To be eligible for QTIP treatment, QTIP trusts must distribute all income at least annually to the surviving spouse. IRC § 2056(b)(7)(B). While QTIP trusts are subject to the same compressed income tax brackets as bypass trusts, since all fiduciary income must be distributed, less taxable income is likely to be accumulated in QTIP trusts at those rates. Keep in mind that the requirement that a QTIP trust must distribute all of its income means only that its income measured under state law and the governing instrument must be distributed to the surviving spouse. IRC § 643(b). In measuring fiduciary accounting income, the governing instrument and local law, not the Code, control. Nevertheless, the "simple trust" mandate that a QTIP trust distribute all of its income at least annually will typically mean that less taxable income is subjected to tax in a QTIP trust than in a bypass trust.

3. New Cost Basis at Second Spouse's Death. If a valid QTIP election is made under Section 2056(b)(7)(B)(v) of the Code, which requires the filing of an estate tax return, then upon the death of the surviving spouse, the assets in the QTIP trust are treated for basis purposes as though they passed from the surviving spouse at the second death. IRC § 1014(b)(10). As a result, they are eligible for a basis adjustment at the death of the surviving spouse. It is important to remember that a QTIP election does not
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have to be made on an all-or-nothing basis, but rather a partial QTIP election may be made. Treas. Reg. § 20.2056(b)-7(b)(2)(i). Accordingly, in providing for the surviving spouse, if the estate plan provides for one trust for the sole benefit of the survivor and the other requirements to qualify the trust as a QTIP trust are met, the executor could make a partial QTIP election (perhaps severing the trust into two parts), resulting in both a bypass trust and a QTIP trust for the surviving spouse's benefit. This technique is often referred to as a "one-lung trust."

4. Preservation of GST Tax Exemption. If no QTIP election is made for the trust by filing an estate tax return, the first spouse to die is treated as the transferor for GST tax purposes, so the deceased spouse's GST tax exemption may be allocated (or may be deemed allocated), thereby preserving the GST tax exemption of that spouse. See IRC § 2632(e)(1)(B). If a QTIP election is made for the trust, the executor may nevertheless make a "reverse" QTIP election for GST tax purposes, again utilizing the decedent's GST tax exemption to shelter the QTIP assets from tax in succeeding generations. See IRC § 2652(a)(3).

5. QTIPs and Portability. From an estate tax standpoint, making the QTIP election means that the assets passing to the QTIP trust will be deductible from the taxable estate of the first spouse, thereby increasing the DSUE amount available to pass to the surviving spouse. IRC § 2056(b)(7). (But see the discussion of Revenue Procedures 2001-38 and 2016-49 at page 28 below.) Of course, the assets on hand in the QTIP trust at the time of the surviving spouse's death will be subject to estate tax at that time as though they were part of the surviving spouse's estate. IRC § 2044. But if the surviving spouse's estate plus the QTIP assets are less than the surviving spouse's basic exclusion amount (or if a portability election has been made, less than the surviving spouse's applicable exclusion amount) then no estate tax will be due.

6. QTIPs and Using the DSUE Amount. One strategy that a surviving spouse might consider, especially if remarriage is a possibility, is to make a taxable gift prior to remarriage (or at least prior to the death of a new spouse) to be sure to capture the DSUE amount of the prior spouse. If the spouse is a beneficiary of a QTIP trust, one possible form of that gift would be to intentionally trigger a gift of the QTIP trust assets under Section 2519 of the Code. Section 2519 provides that if a surviving spouse releases any interest in a QTIP trust, transfer taxes are assessed as though the entire QTIP trust (other than the income interest) had been transferred. If the surviving spouse were to release a very small interest in the QTIP trust, the result would effectively be to make a gift of the entire QTIP, thereby using his or her DSUE amount, even though the surviving spouse would retain the use of the unreleased income interest. By making a gift of some interest in the QTIP trust while retaining the income interest, the trust assets will be included in the surviving spouse's estate at death, thereby receiving a new cost basis. IRC § 1014(b)(4).

Example 11: W has a $5 million estate. W dies with a Will leaving all to a QTIP trust for H. W's executor files an estate tax return making both the QTIP and the portability elections. Immediately thereafter, H releases 0.5% of the income interest in the QTIP trust assets. The release of the income interest is a taxable gift of the 0.5% interest under Section 2511 of the Code, but more importantly, the release also constitutes a gift of the balance of the trust assets under Section 2519. Because the interest retained by H is not a qualified annuity interest, Code Section 2702 precludes any discounts when valuing that interest. The effect is for H to have made a $5 million gift, all of which is sheltered by W's DSUE amount. Even though the DSUE amount has been used, H still retains 99.5% of the income from the QTIP trust for life. In addition, the QTIP trust assets are included in H's estate under Code Section 2036, so a new cost basis will

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18 This technique is discussed in detail in Franklin and Karibjanian, Portability and Second Marriages—Worth a Second Look, 39 TAX MGMT. ESTS. GIFTS & TRUST J. 179 (2014).
be determined for the assets when H dies. Because the assets are not included in the estate under Section 2044 of the Code, the taxable gift will not be treated as an adjusted taxable gift when H dies.

D. QTIP Trust Disadvantages

Even in the current tax regime, QTIP trusts pose some disadvantages when compared to bypass trusts. In particular:

1. **No "Sprinkle" Power.** Because the surviving spouse must be the sole beneficiary of the QTIP trust, the trustee may not make distributions from the QTIP trust to persons other than the surviving spouse during the surviving spouse's lifetime. IRC § 2056(b)(7)(B)(ii)(II). As a result, unlike the trustee of a bypass trust, the trustee of a QTIP trust cannot "sprinkle" trust income and principal among younger-generation family members. Of course, this places the surviving spouse in no worse position than if an outright bequest to the spouse had been made. The surviving spouse can still use his or her own property to make annual exclusion gifts to those persons (or after a portability election, make even larger taxable gifts by using his or her DSUE amount) without paying any gift tax.

2. **Estate Tax Exposure.** Presumably, the QTIP trust has been used in order to achieve a step-up in basis in the inherited assets upon the death of the surviving spouse (which, of course, assumes that the trust assets appreciate in value—remember that the basis adjustment may increase or decrease basis). The basis adjustment is achieved by subjecting the assets to estate tax at the surviving spouse's death. The premise of using this technique is that the surviving spouse's basic exclusion amount (or applicable exclusion amount, if portability is elected) will be sufficient to offset any estate tax. There is a risk, however, that the "guess" made about this exposure may be wrong. Exposure may arise either from growth of the spouse's or QTIP trust's assets, or from a legislative reduction of the estate tax exemption, or both. If these events occur, use of the QTIP trust may expose the assets to estate tax. Again, this risk is no greater than if an outright bequest to the spouse had been made. However, if the source of the tax is appreciation in the value of the QTIP trust assets between the first and second death, and if the income tax savings from the basis adjustment is less than the estate taxes payable, then with hindsight, one could argue that using a bypass trust instead would have been more beneficial to the family.

3. **Income Tax Exposure.** A QTIP trust is a "simple" trust for federal income tax purposes, in that it must distribute all of its income at least annually. Remember, however, that simple trusts may nevertheless pay income taxes. As noted above, a trust which distributes all of its "income" must only distribute income as defined under the governing instrument and applicable state law (typically, the Uniform Principal and Income Act), which is not necessarily all of its taxable income. Thus, for example, capital gains, which are taxable income, are typically treated as corpus under local law and thus not distributable as income. Other differences between the notions of taxable income and state law income may further trap taxable income in the trust. Although simple trusts often accumulate less taxable income than complex trusts, they may nevertheless be subject to income tax at compressed tax rates.

4. **Is a QTIP Election Available?** In Revenue Procedure 2001-38, 2001-1 CB 1335, the IRS announced that "[i]n the case of a QTIP election within the scope of this revenue procedure, the Service will disregard the election and treat it as null and void" if "the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes." The Revenue Procedure provides that to be within its scope, "the taxpayer must produce sufficient evidence" that "the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes." *Id.* (emphasis added). The typical situation in which the Revenue Procedure applies is the case where the taxable estate would have been less than the basic exclusion amount, but the executor listed some or all of the trust property on Schedule M of the estate tax return and thus made an inadvertent and superfluous QTIP election.

An executor must file an estate tax return to elect portability, even if the return is not otherwise required to be filed for estate tax purposes. In that case, a QTIP election is not required to reduce the federal estate tax, because there will be no estate tax in any event. However, a QTIP election might still be made to maximize the DSUE amount, gain a second basis adjustment at the death of the surviving spouse, and support a reverse-QTIP election for GST tax purposes. Until recently, the concern was that Revenue
Procedure 2001-38 could mean that the IRS might determine that a QTIP election made on a portability return "was not necessary to reduce the estate tax liability to zero" and therefore treat the QTIP election as "null and void." Adding to those concerns, when issuing final regulations with regard to making a portability election, the IRS stated that it would later issue guidance addressing whether a QTIP election made under Section 2056(b)(7) may be disregarded and treated as null and void when an executor has elected portability of the DSUE amount.

Thankfully, on September 27, 2016, the IRS issued Revenue Procedure 2016-49, 2016-42 IRB 462, which modifies and supersedes Revenue Procedure 2001-38 and outlines new procedures under which the IRS will disregard a QTIP election, but it provides that these procedures are unavailable if a portability election was made for the DSUE amount under Section 2010(c)(5)(A). The IRS will, however, continue to disregard an unnecessary QTIP election and treat the election as null and void solely "for estates in which the executor neither has made nor has considered to have made the portability election."

Specifically, Revenue Procedure 2016-49 treats QTIP elections as void if three requirements are satisfied: (1) the estate's federal estate tax liability was zero, so the QTIP election is unnecessary to reduce federal estate tax liability; (2) the executor did not make and was not considered to have made a portability election under Section 2010(c)(5)(A); and (3) specific procedural requirements for relief to treat a QTIP election as void as outlined in Section 4.02 of the Revenue Procedure are satisfied.

Conversely, the revenue procedure does not treat as void a QTIP election in any of the following situations: (1) a partial QTIP election was required for a trust to reduce estate tax liability but the executor made the election for more property than was necessary to bring the estate tax liability to zero; (2) a QTIP election was made "in terms of a formula designed to reduce the estate tax to zero"; (3) the QTIP election constituted a protective election under Treasury Regulation Section 20.2056(b)-7(c); (4) the executor made a portability election "even if the decedent's DSUE amount was zero based on values as finally determined for federal estate tax purposes"; or (5) the procedural requirements for relief to treat a QTIP election as void as outlined in Section 4.02 of the Revenue Procedure are not satisfied.

The Revenue Procedure also notes that, going forward, the procedures set out in the Revenue Procedure "must be used in lieu of requesting a letter ruling." In addition, QTIP elections for which relief was granted under Revenue Procedure 2001-38 do not fall within the scope of Revenue Procedure 2016-49.

Thus, Revenue Procedure 2016-49 accomplishes three things. First, taxpayers now have certainty that a QTIP election made solely to increase a DSUE amount will not be ignored or treated as void. Second, it expands the grounds for automatic relief for invalidating QTIP elections when the election provides no benefit. Third, as IRS user fees for private letter rulings continue to climb, taxpayers can now rely on Revenue Procedure 2016-49 for certainty in lieu of a costly and lengthy private letter ruling process.

5. **Clayton QTIP Trusts.** When the statute authorizing QTIP trusts was first enacted, the IRS strictly construed language in Section 2056(b)(7) of the Code requiring the property in question to pass from the decedent. In *Estate of Clayton v. Commissioner*, 97 TC 327 (1991), the IRS asserted that no marital deduction was allowed if language in the will made application of QTIP limitations contingent upon the executor making the QTIP election. Regulations at the time also adopted this position. After the Tax Court found in favor of the IRS's position, the Fifth Circuit reversed and remanded, holding that language in a will that directed property to a bypass trust to the extent no QTIP election was made did not jeopardize the estate tax marital deduction. *Est. of Clayton v. Comm'n*, 976 F2d 1486 (5th Cir. 1992). After other courts of appeal reached the same result and a majority of the Tax Court abandoned its position, the Commissioner issued new regulations that conform to the decided cases and permit a different disposition of the property if the QTIP election is not made. Treas. Reg. §§ 20.2056(b)-7(d)(3)(i), 20.2056(b)-7(h), (Ex. 6). The final regulations explicitly state that not only can the spouse's income interest be contingent on the election, but the property for which the election is not made can pass to a different beneficiary, a point that was somewhat unclear under the initial temporary and proposed regulations issued in response to the appellate court decision. As a result, it is now clear that a will can provide that if and to the extent that a QTIP election is made, property will pass to a QTIP trust, and to the extent the election is not made, the property will pass elsewhere (for example, to a bypass trust). Including this *Clayton* QTIP language in
a client's will would allow the executor of the estate of the first deceased spouse additional time compared to a disclaimer bypass trust to evaluate whether a QTIP or bypass trust is best. Because the QTIP election would need to be made on a federal estate tax return, the Clay option would require the filing of an estate tax return if property is to pass to the QTIP trust. Presumably, since a QTIP election can be made on an estate tax return filed on extension, a Clay QTIP would give the executor fifteen months after the date of death to evaluate the merits of the election. In addition, since no disclaimer is involved, there is no limitation on the surviving spouse holding a special testamentary power in the bypass trust that receives the property as a result of the Clay election. Sample language invoking a Clay QTIP trust is attached as Exhibit D.

If a Clay QTIP election is contemplated, may the surviving spouse serve as the executor? There is a concern that the spouse's right to alter the form of her bequest from a bypass trust that may "sprinkle and spray" among family members to an "all income for life" QTIP trust might give rise to gift tax exposure to the spouse for making (or failing to make) the election. Most commentators agree that the safest course is for the spouse not to serve as executor. A somewhat more aggressive approach may be for the spouse to serve, but to require the surviving spouse/executor to make (or not make) the QTIP election as directed by a disinterested third party. Note that these concerns should not apply to a one-lung trust because a partial QTIP election does not alter the surviving spouse's beneficial interest.

6. The QTIP Tax Apportionment Trap. Remember that if estate tax ultimately proves to be due as a result of having made the QTIP election, the source of payment for these taxes becomes important. Under federal law, except to the extent that the surviving spouse in his or her will (or a revocable trust) specifically indicates an intent to waive any right of recovery, the marginal tax caused by inclusion of the QTIP assets in the surviving spouse's estate is recoverable from the assets of the QTIP trust. IRC § 2207A(1). Many state tax apportionment statutes adopt this rule, either expressly or by reference. See, e.g., TEX. ESTS. CODE § 124.014. When the beneficiaries of the surviving spouse's estate and the remainder beneficiaries of the QTIP trust are the same persons, this rule generally makes little difference. Where they differ, however, the result could be dramatic, and highlights the need to check the "boilerplate" of clients' wills.

Example 12: H and W each have a $10 million estate. H dies with a Will leaving all to a QTIP trust for W, with the remainder interest in the trust passing upon W's death to H's children from a prior marriage. H's executor files an estate tax return making both the QTIP and the portability elections. W immediately thereafter, knowing she can live from the QTIP trust income, makes a gift of her entire $10 million estate to her children. No gift tax is due since W can apply her applicable exclusion amount to eliminate the tax (i.e., her basic exclusion amount plus H's DSUE amount of $5 million). Upon W's later death, the remaining QTIP trust assets are subject to estate tax under Section 2044 of the Code. Since W used all of her applicable exclusion amount to shelter her gift to her children, none of her exemption (or a nominal amount because of the inflation adjustment of her basic exclusion amount) is available to shelter estate tax, and the entire $10 million (assuming no changes in value) is taxed. All of this tax is attributable to the QTIP trust assets, so unless W's Will expressly provides otherwise, the estate tax liability of $4 million is charged to the trust (and therefore, in effect, to H's children). As a result, H's children are left with $6 million from the remainder of the QTIP assets, while W's children receive $10 million tax free.

One solution to this problem may be to have H's executor agree to the portability election only if W (i) agrees to waive estate tax recovery under Section 2207A except to the extent of pro rata taxes (instead of marginal taxes); and (ii) agrees to retain sufficient assets to pay applicable estate taxes associated with her property transfers, whether during lifetime or at death. As one might imagine, drafting such an agreement would not be a trivial matter.

E. Is a "LEPA" Trust a Better Choice?

A QTIP trust isn't the only method of obtaining a marital deduction for property passing into trust for a surviving spouse. Long before the advent of QTIP marital trusts, another form of marital trust was
available. Unlike the more familiar QTIP trust format, this trust is available without the need to file an estate tax return.

1. Structure of LEPA Trusts. Section 2056(b)(5) of the Code permits a marital deduction for property passing into trust for a spouse so long as the surviving spouse is entitled for life to the income from all or a specific portion of the trust, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the trust property (exercisable in favor of the surviving spouse or the estate of the surviving spouse, or in favor of either, whether or not the power is exercisable in favor of others), so long as no power is given to anyone to appoint any part of the trust to anyone other than the surviving spouse. This so-called Life Estate Power of Appointment ("LEPA") trust thereby allows a marital deduction without many of the other restrictions applicable to QTIP trusts. Note that the spouse must be given the right to income from all of the trust (or a specific portion of the trust determined on a fractional or percentage basis) that is intended to qualify. The power of appointment must be exercisable by the surviving spouse alone, and may be inter vivos or testamentary, as long as it is exercisable over all of the trust property from which the spouse has a right to the income. IRC § 2056(b)(5).

2. Benefits of LEPA Trusts. Since the advent of QTIP trusts, estate planners have generally preferred them, since they allow the creator of the trust to restrict the disposition of any trust property remaining at the death of the surviving spouse, by restricting or even eliminating the surviving spouse's power to appoint the trust property. However, LEPA trusts do cause inclusion in the surviving spouse's estate, thereby providing a basis adjustment in the trust's assets at the death of the surviving spouse. IRC § 1014(b)(4). In addition, they provide many of the other trust benefits such as creditor protection and divorce protection, as well as management assistance through the use of a trustee or co-trustee other than the spouse. While neither the income nor the associated tax liability of a LEPA trust may be shifted to others, a LEPA trust may avoid application of compressed tax rates if the surviving spouse has a general power to appoint property to him- or herself during lifetime. IRC § 678. Especially in smaller estates of couples with children of the same marriage, and in states with no state estate tax, the LEPA trust may see a rise in popularity because couples with smaller estates don't need to file an estate tax return to obtain the second basis adjustment.

3. Disadvantages of LEPA Trusts. LEPA trusts do have some drawbacks. Most notably, while a QTIP trust permits preservation of the decedent's GST tax exemption by making a "reverse" QTIP election for GST tax purposes, there is no "reverse" LEPA election. Assets in the trust are simply included as part of the surviving spouse's estate at the time of his or her death, and the surviving spouse is thereby treated as the transferor of the trust property for GST tax purposes. In addition, granting the surviving spouse a general testamentary power of appointment over trust assets may not be compatible with every client's estate plan. Also, the grant of a general power of appointment, whether inter vivos or testamentary, may subject the property to the spouse's creditors.

V. ADDRESSING INCOME TAX ISSUES

Marital trust planning, whether taking the form of QTIP or LEPA trusts, can allow clients to obtain many of the income tax basis benefits of the outright/portability option, while at the same time achieving the estate preservation and asset protection planning advantages of a bypass trust. Thus, marital trusts can help solve the "loss-of-basis" disadvantages of bypass trusts discussed above, and can solve many of the disadvantages of outright planning. But is there an even better solution? Marital trusts, by causing trust property to be included in the surviving spouse's estate, actually achieve a full basis adjustment, which means that the assets in the trust receive not only a second step-up in basis if they appreciate, but also a second step-down in basis if their values decline. In addition, unlike bypass trusts, marital trusts cannot "sprinkle" income and assets to other beneficiaries. Moreover, they are somewhat "leaky," for both asset protection and income tax reasons, because of their mandatory income requirements.
A. Creative Options to Create Basis.

Estate planners have suggested a number of other tools that could be brought to bear on the drawbacks presented by bypass trusts. Each of these options have advantages and disadvantages, and it appears that there may be no "one-size-fits-all" (and perhaps not even a "one-size-fits-most") solution to the problem.

1. Distribution of Low-Basis Assets. Perhaps the most straight-forward approach involves simply having the trustee of a bypass or other trust distribute to the surviving spouse low basis assets with a total value that, when added to the value of the surviving spouse's other assets, will cause his or her estate to be less than his or her available applicable exclusion amount. If the distribution can be justified as having been made for the spouse's health, education, maintenance or support (or however the trust's applicable distribution standard reads), then arguably, this distribution could be undertaken with no other special language in the governing instrument. So long as the spouse passes these assets at death to the same person(s) who would have received them from the trust, there is presumably no one to complain. The remaindermen receive the assets with a higher cost basis, so they are actually better off than if the distribution had never been made. This approach has several shortcomings. For example: (i) the trustee must identify the low-basis assets and distribute them to the spouse in the proper amount, presumably shortly before the spouse passes away; (ii) if the surviving spouse dies with substantial creditors or changes his or her dispositive plan before death, the remaindermen may be injured by the distribution (for which the trustee could presumably be liable if it can be shown that the distribution was not made pursuant to the applicable distribution standard); and (iii) if the surviving spouse truly has no need for the distribution, the IRS might argue that the distribution was unauthorized, asserting that a constructive trust or resulting trust was thereby imposed for the remainder beneficiaries, effectively excluding the assets from the spouse's estate (and precluding any step-up in basis). See Stansbury v. U.S., 543 F. Supp. 154 (N.D. Ill. 1982), aff'd, 735 F.2d 1367 (7th Cir. 1984) (holding, in an entirely different context, that assets subject to a constructive trust were excluded from the estate of the nominal owner for estate tax purposes); Est. of Halpern v. Comm'r, TC Memo 1995-352 (Tax Court analyzed IRS argument that unauthorized trust distributions should be included in decedent's estate in light of how decedent would have prevailed if he had pursued recovery in state court); PLR 9338011 (holding that assets improperly distributed to a trust beneficiary would be deemed under local law to be held in a "resulting trust," and as a result, were not includable in the decedent's estate under IRC § 2033).

2. Granting Broad Distribution Authority to a Third Party. One option may be to designate an independent trustee (or co-trustee, or "distribution trustee") in a bypass trust, and to grant that person broad discretion to distribute up to the entire amount in the bypass trust to the surviving spouse. The theory would be that if the surviving spouse were nearing death with an estate valued below his or her applicable exclusion amount, the person holding this authority could simply distribute low-basis assets to the surviving spouse outright, thereby causing them to be included in the surviving spouse's estate, thus receiving a new cost basis at death. This authority could also be exercised more broadly if the family simply decided that the benefits of the bypass trust were not worth its costs (or not worth it as to certain assets), and the trustee/trust protector agreed to distribute the assets. Since the surviving spouse would not hold this authority, the assets remaining in the bypass trust would not be included in his or her estate. So long as the trustee/trust protector were not a remainder beneficiary of the trust, no gift would arise as a result of the exercise (or non-exercise) of the power. However, one would need to ensure that appropriate successors were named in case the first designated person failed or ceased to serve, and it would be prudent not to allow the surviving spouse or other beneficiaries of the trust to remove, replace, or fill a vacancy in the position by a person related to or subordinate to the trust beneficiaries under Code Section 672(c). IRC § 672(c); see Rev. Rul. 95-58, 1995-2 CB 191.

 Critics of this approach note that it is often impractical and requires considerable proactivity and perhaps even omniscience (not to mention potential liability) for the trustee/trust protector. Is it possible to find one person (let alone one or more back-ups) to fill this role? Can we expect the trustee/trust protector to know when the surviving spouse is likely to die, to know the cost basis of trust assets and to know an accurate net worth of the surviving spouse? Some posit that the duty could be drafted to arise only upon the request of the surviving spouse or one (or all) of the remainder beneficiaries. Even in that case, it seems likely that the trustee/trust protector may wish to hire counsel, to analyze the medical condition of the
spouse, get signed waivers, and/or consult a distribution committee, time for which may be scarce in a situation where the surviving spouse is hospitalized or terminally ill. And, what happens if the spouse gets better? Finally, an outright distribution of property to the surviving spouse would subject the distributed property to the claims of the creditors of the surviving spouse, which could in a worst-case scenario be the equivalent of a 100% "tax" on the distributed assets.

3. **Giving a Third Party the Power to Grant a General Power of Appointment.** A related technique advocates giving an independent trustee or trust protector not the distribution authority directly, but rather the power to grant to the surviving spouse (or others) a general testamentary power of appointment. The idea is that if it is apparent that no estate tax will be due upon the survivor's death, the power could be exercised to grant the spouse a general power, and thereby achieve a basis adjustment. This approach might protect the trust assets from creditors during the surviving spouse's lifetime, but it suffers from many of the same shortcomings as the technique just described. In particular, (i) it must have been included in the governing instrument; (ii) a person (or persons) willing and able to hold this power must be identified; (iii) the person must be willing to exercise the authority at the right time; and (iv) the surviving spouse might actually exercise the power and divert the assets outside the family. Any person given this authority must be concerned about being held liable by the trust's remaindermen for improvidently exercising (or failing to exercise) the power, or by the spouse if the power is exercised at a time when the spouse is expected to die but doesn't. More problematic is the concern that under Code Section 2041(b)(1)(C)(iii) a general power of appointment that is exercisable in conjunction with another person is nevertheless a general power if the other person does not have an adverse interest, and it is a general power as to the entire value of the trust property if the other person is not a permissible appointee. A trust protector would typically not have an adverse interest or be a permissible appointee. At least one commentator has questioned whether there is any real difference between a power that is conferred by the protector and a power that is conferred to the surviving spouse. RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 17.1 (2011). Since the power would be granted with the express authority to exercise it (or not exercise it) in a non-fiduciary capacity, the power holder should be less concerned about exposure to claims of imprudence by trust beneficiaries. If the person holding the power is a beneficiary of the trust, its exercise may cause gift tax concerns. See Treas. Reg. §§ 25.2514-1(b)(2), -3(e), Ex. 3; PLR 8535020; PLR 9451049. If the person holding the power is not a beneficiary, however, the exercise or non-exercise of the power should have no tax implications to the power holder. But, as noted with respect to distributions by an independent trustee or trust protector, appointing assets outright to the surviving spouse risks subjecting those assets to the spouse's creditors, and further exposes family members to the risk that the surviving spouse may disinherit them. In this regard, trust assets are a bit like toothpaste: once the assets are out of the trust "tube," you can't simply put them back in and have the same tax results.

4. **Granting a Non-Fiduciary Power to Appoint to the Surviving Spouse.** Some commentators have suggested that the fiduciary liability concerns associated with giving a trustee or trust protector broad distribution rights could be overcome by giving another party (typically a child, perhaps another family member, friend of the spouse, or non-beneficiary), a non-fiduciary limited lifetime power to appoint property to the surviving spouse. A power of appointment granted in a non-fiduciary capacity may be exercised arbitrarily. RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 17.1 (2011). Since the power would be granted with the express authority to exercise it (or not exercise it) in a non-fiduciary capacity, the power holder should be less concerned about exposure to claims of imprudence by trust beneficiaries. If the person holding the power is a beneficiary of the trust, its exercise may cause gift tax concerns. See Treas. Reg. §§ 25.2514-1(b)(2), -3(e), Ex. 3; PLR 8535020; PLR 9451049. If the person holding the power is not a beneficiary, however, the exercise or non-exercise of the power should have no tax implications to the power holder. But, as noted with respect to distributions by an independent trustee or trust protector, appointing assets outright to the surviving spouse risks subjecting those assets to the spouse's creditors, and further exposes family members to the risk that the surviving spouse may disinherit them. In this regard, trust assets are a bit like toothpaste: once the assets are out of the trust "tube," you can't simply put them back in and have the same tax results.

5. **Decanting the Bypass Trust to a Trust that Provides Basis.** If the bypass trust does not by its terms contain provisions that would allow a basis adjustment at the death of the surviving spouse, some commentators have suggested that the trust be modified or decanted into a trust that has more favorable terms. While the intricacies of trust modifications and decanting are well beyond the scope of this paper, one need only note that this form of decanting may not be available in all jurisdictions. For example, under the current Texas decanting statute, no change may be made to the dispositive (as opposed to administrative) provisions of a trust via decanting unless the trustee's power to make distributions is not

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limited in any way.  See generally TEX. PROP. CODE § 112.073 (stating the law governing distribution of property in a second trust when the trustee has limited discretion). It isn't merely a "health, education, maintenance and support" standard that causes a trustee's powers to be limited in Texas. Rather, literally any restriction on trustee powers imposes these limits. See TEX. PROP. CODE § 112.072(a). In addition, even if a trustee has unlimited discretion (a true rarity, and one which would seem to obviate the need to decant to achieve the aims discussed above), under current Texas law, no decanting may occur if it will "materially impair the rights of any beneficiary," although this provision is deleted from the statute effective September 1, 2017. TEX. PROP. CODE § 112.085(2). Decanting to a trust that grants a spouse broad powers of appointment might "materially impair" the rights of remainder beneficiaries. Finally, no matter the state involved, a trustee's power to decant is subject to the trustee's overall fiduciary duties, and may have tax consequences apart from achieving the basis aims discussed here. For a thorough discussion of decanting generally, see Willms, Decanting Trusts: Irrevocable, Not Unchangeable, 6 EST. PLAN. & COMMUNITY PROP. L. J. 35 (2013).

6. Making a Late QTIP Election. If the bypass trust happens to otherwise qualify as a QTIP trust, and no federal estate tax return was ever filed to not make a QTIP election, it may be possible to file an estate tax return to make a late QTIP election. Although somewhat rare, some bypass trusts qualify for QTIP treatment with a proper election. Specifically, the bypass trust must provide that the surviving spouse is the sole beneficiary during his or her lifetime, is entitled to demand or receive all net income at least annually, and can require unproductive property be made productive. Somewhat surprisingly, a QTIP election can be made on the last timely filed estate tax return, or, if no return is filed on time, on the first late-filed return. Treas. Reg. § 20.2056(b)-7(b)(4)(i). That means that long after the fact (conceivably, even after the death of the surviving spouse) a return could be filed that relates back to the time of the first spouse's death, thereby causing the trust assets to be included in the surviving spouse's estate and resulting in basis adjustment in the trust's assets at the second death. Note that it is unlikely that anything like surgical precision would be possible in this circumstance. Although partial QTIP elections are permitted, it is unlikely that the election could be made only as to those assets whose values increased between the first and second death. See Treas. Reg. § 20.2056(b)-7(b)(2).

7. Investing in Life Insurance. While there has been much wringing of hands about the loss of basis adjustment for assets held inside a bypass trust, that concern is premised upon the trust holding assets that appreciate during the surviving spouse's lifetime which, when liquidated, will generate taxable gain. Consider, however, a bypass trust that holds or purchases a life insurance policy on the life of the surviving spouse. Regardless of the amount invested in the policy, the death benefit, received in cash, will be income tax free to the beneficiary of the policy (e.g., the bypass trust or its remainder beneficiaries). IRC § 101(a)(1). No "step-up" in basis is required to obtain a favorable income tax result for this investment, since the cash proceeds in effect have a basis equal to the amount paid under the policy. If funds are needed during the surviving spouse's lifetime for his or her health, support, maintenance or education, the trustee can typically borrow from the insurance policy's cash value and use the income-tax-free loan proceeds to make distributions to or for the benefit of the spouse, so long as the policy is not a "modified endowment contract" as defined in Section 7702A of the Code. IRC § 72(e)(10). If the spouse's health declines, the trustee could obtain a pre-payment of the death benefits if available under the policy. If the trustee of the bypass trust elects to receive payments at a time when the insured is terminally ill or chronically ill, the payments may be excluded from gross income. IRC § 101(g). The exclusion for prepayment of accelerated death benefits applies only to payments received from the insurance company that issued the policy, or from certain licensed third party "viatical settlement providers." To be considered "terminally ill," the insured must be certified by a physician as having an illness or physical condition which can reasonably be

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20 For a more recent version of this paper, see Willms, Decanting Trusts: Irrevocable, Not Unchangeable, presented to the Corpus Christi Estate Planning Council (March 2015), available at http://tinyurl.com/o7rnh7w. Note that the paper does not include amendments to the Texas decanting statutes that will be effective as of September 1, 2017.

21 If the insured is chronically ill, payments of certain death benefits are tax-free only if detailed requirements are met. For example, the payment must be for costs incurred for qualified long-term care services. These costs include both medical services and maintenance or personal care services provided under a prescribed plan of care. Also, the payment must not be for expenses reimbursable under Medicare, other than as a secondary payor. IRC § 101(g)(3).
expected to result in death in 24 months or less. IRC § 101(g)(4)(A). A person is considered "chronically ill" if he or she is unable to perform, without "substantial assistance," at least two activities of daily living for at least 90 days due to a loss of functional capacity, or because of severe cognitive impairment, requires substantial supervision to protect him or her. See IRC §§ 101(g)(4)(B); 7702(c)(2)(A). The exclusion for chronically ill taxpayers is subject to a per-diem cap ($360 per day, or $131,400 per year for 2017). IRC §§ 101(g)(3)(D); 7702B(d); Rev. Proc. 2016-55, 2016-45 IRB 707, § 3.55. Naturally, care must be taken to ensure that the spouse, whether as trustee of the bypass trust or otherwise, does not hold any incidents of ownership over the policy. Otherwise, the death benefit of the policy will be included in the spouse's estate for estate tax purposes and may thus be subject to estate tax. IRC § 2042(2).

B. The Optimal Basis Increase Trust ("OBIT").

In an ideal world, estate planners would design a trust that ensures that upon the surviving spouse's death, its assets get a step-up, but not a step-down in basis, doesn't generate any federal estate tax (or any extra state estate tax), achieves better ongoing income tax savings than a typical bypass or marital trust, and preserves asset protection benefits, all without the drawbacks described above. One approach to such a trust has been suggested by attorney Edwin P. Morrow, III who describes employing a combination of techniques with a bypass/marital trust plan to create what he refers to as an "Optimal Basis Increase Trust" or "OBIT."22 The key feature of this plan is to make creative use of testamentary general and limited powers of appointment to (i) assure that assets in the trust receive a step-up in basis, but never a step-down in basis; and (ii) dynamically define or invoke these powers so as not to cause additional estate tax.

1. Granting a General Power of Appointment to Obtain Basis. As part of a traditional bypass trust, an OBIT might grant the surviving spouse a testamentary limited power of appointment (or no power at all) over all IRD assets (which cannot receive a new cost basis) and over assets with a basis higher than the fair market value at the time of the surviving spouse's death (for which no new basis is desired). However, it would grant the surviving spouse a general testamentary power of appointment ("GPOA") over any assets that have a fair market value greater than their tax basis.23 Such a "split" power of appointment would assure that appreciated assets in the trust would receive a step-up in basis, but no assets would receive a step-down.

2. Applying a Formula to Avoid Estate Tax. What if the value of the appreciated assets in the bypass trust, when added to the value of the surviving spouse's estate, exceeds the surviving spouse applicable exclusion amount at the time of his or her death? In that event, basis would be acquired, but at the cost of paying estate tax. One alternative is to restrict the surviving spouse's GPOA by a formula. The formula would, in effect, provide that the GPOA is only applicable to appreciated trust assets to the extent it does not cause increased federal estate tax. (As a further refinement, the formula might also take into account state estate tax, if it is potentially applicable). Estate planners have been drafting formula powers of appointment for years (usually in the context of avoiding GST taxes) which limit the scope of the GPOA either as to appointees or assets. There is no reason one cannot grant a general power of appointment over less than 100% of trust assets, or by formula. See Treas. Reg. § 20.2041-1(b)(3). In fact, one might further fine-tune the formula to limit its application first to those assets with the greatest embedded gain (or those assets whose sale would result in the most federal income tax, taking into consideration not only the amount but the character of the gain involved). In this regard, the drafting difficulty arises not so much with describing the upper limit on the GPOA, but in creating an ordering rule which appropriately adjusts the formula based upon the circumstances that one might reasonably expect to be applicable at the death of the surviving spouse.24

23 As discussed below, this targeted estate tax inclusion and resulting basis adjustment may also be accomplished by granting the surviving spouse a limited power of appointment that is exercised in a manner to trigger the Delaware Tax Trap.
24 Morrow notes: Assets that may incur higher tax rates, such as collectibles . . . 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
3. Designing the Formula. In its simplest form, the formula GPOA might apply to a pecuniary amount rather than to specific assets. However, funding such a pecuniary amount would require the trustee to determine the assets over which it applies. That discretion might result in undesired income tax consequences. In particular, distributions that satisfy a pecuniary obligation of the trust are recognition events for the trust. The fair market value of the property is treated as being received by the trust as a result of the distribution; therefore, the trust will recognize any gain or loss if the trust's basis in the property is different from its fair market value at the time of distribution. Rev. Rul. 74-178, 1974-1 CB 196. Thus, gains or losses could be recognized by the trust if the formula gift describes a pecuniary amount to be satisfied with date-of-distribution values, as opposed to describing specific trust assets or a fractional share of the trust. See Treas. Reg. §§ 1.661(a)-2(f)(1), 1.1014-4(a)(3); Rev. Rul. 60-87, 1960-1 CB 286. As a result, one should avoid simple powers of appointment over, for example, "assets with a value equal to my [spouse's] remaining applicable exclusion amount."

On the other hand, if the surviving spouse's testamentary power potentially extends to all of the applicable property equally, but is fractionally limited, all property subject to that provision should get a fractional adjustment to basis. A pro rata adjustment would result in wasted basis adjustments, since a $1,000,000 asset with $1 gain would use just as much of the surviving spouse's applicable exclusion amount as a $1,000,000 asset with $900,000 gain. The result would be better than no extra basis at all, but not as optimal as the trustee limiting the surviving spouse's GPOA, or establishing an ordering rule to determine to which specific property the power pertains.25

By specifying that the GPOA applies on an asset-by-asset basis to the most appreciated asset first, cascading to each next individual asset until the optimal amount is reached, the difficulty with pecuniary funding can likely be avoided. Since the ordering formula necessarily means that the GPOA could never apply to depreciated assets, the IRS would have no statutory basis to include them in the surviving spouse's estate (or accord them an adjusted basis). The GPOA would apply to specific property, and not a dollar amount or a fraction. Applying the formula would likely require the creation by the trustee of a rather elaborate spreadsheet when dealing with numerous individual assets (think of brokerage accounts with dozens of individual stock positions), but the result would be a well ordered cascade of basis increase.26

If the spouse serves as the (or a) trustee, might the IRS argue that he or she has an indirect power to manipulate gains and losses on investments, and therefore basis, which in effect gives the spouse a GPOA over all of the trust's assets up to the remaining applicable exclusion amount? Presumably not. Treasury Regulation Section 25.2514-1(b)(1) provides that "[t]he 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.'"

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25 Morrow suggests that an independent trustee might be given a fiduciary limited power of appointment to choose the appointive assets subject to the surviving spouse's GPOA. The trustee's fiduciary power could arguably limit the spouse's GPOA over only specific assets chosen by the trustee, since the trustee's power would also be limited. While this is fundamentally different in many ways from traditional marital deduction funding formulas that involve trustee choice, the IRS could conceivably seek to apply a "fairly representative" requirement, or otherwise impose limits on trustee authority comparable to those described in Rev. Rul. 64-19, 1964-1 CB 682. See Davis, Funding Unfunded Testamentary Trusts, 48 U. MIAMI HECKERLING INST. ON EST. PL. ch. 8, ¶ 804.3 (2014). Morrow concludes that the more conservative and simpler approach is probably just to make it clear that the GPOA never applies to the less appreciated assets, and is never subject to any power holder's discretionary choice.

26 For a formula that seeks to exercise a power of appointment in this cascading asset-by-asset fashion (although in the context of springing the "Delaware Tax Trap" which is discussed below), see Exhibit E.
4. Limiting the GPOA to Avoid Diversion of Assets and Loss of Asset Protection. Just how broad of a general power must the surviving spouse have to obtain a new cost basis? From a tax standpoint, the goal of the formula GPOA should be like an often-expressed wish for children (to be seen but not heard) or perhaps like a grantor’s intent with typical *Crummey* withdrawal rights (to be granted but not exercised). After all, it is the *existence* of the GPOA that gives rise to the basis adjustment—not its exercise. The IRS has historically had every incentive to find a GPOA even on the narrowest of pretexts, since in the past, a GPOA typically produced more revenue in the form of estate tax than it lost by virtue of basis adjustments. Courts have gone along, finding a GPOA to exist even where the holder of the power didn’t know it existed, or couldn’t actually exercise it due to incapacity. See, e.g., *Fish v. U.S.*, 432 F2d 1278 (9th Cir 1970), *Est. of Alperstein v. Comm'r*, 613 F2d 1213 (2nd Cir 1979), *Williams v. U.S.*, 634 F2d 894 (5th Cir. 1981). The breadth of the statutory language and Treasury regulations in finding a GPOA, together with favorable law in the asset protection context, mean that GPOAs can be drafted to pose little threat to the estate plan.

If a LEPA trust (described above at page 30) is used, the general power of appointment must include the spouse or spouse’s estate (and not just creditors of the spouse’s estate), and must be "exercisable by such spouse alone and in all events." IRC § 2056(b)(5). However, if no marital deduction is to be claimed, as is typically the case with a bypass trust OBIT, some limitations may be included.

For example, a GPOA may limit the scope of eligible beneficiaries so long as creditors of the power holder are included. As an illustration:

My [spouse] shall have a testamentary power to appoint, outright or in trust, any property remaining in the trust to any one or more persons related to me by blood, marriage or adoption or to any charity or charities. In addition, my [spouse] shall have a testamentary power to appoint [optimal trust property] to the creditors of [his/her] estate.

See IRC § 2041(b)(1); Treas. Reg. § 20.2041 3(c)(2); *Jenkins v. U.S.*, 428 F2d 538, 544 (5th Cir. 1970).

Furthermore, as noted earlier, a general power is still a GPOA if it may only be exercised with the consent of a non-adverse party. IRC § 2041(b)(1)(C)(ii). In fact, even a trustee that owes fiduciary duties to beneficiaries whose interests are adverse to the power holder is not, by that status alone, considered adverse. See Treas. Reg. § 20.2041-3(c)(2), Ex. 3; *Est. of Jones v. Comm'r*, 56 TC 35 (1971); *Miller v. U.S.*, 387 F2d 866 (3rd Cir. 1968). For example, one might add to the above language: "However, my [spouse] may exercise [his/her] power of appointment only with the consent of [name of non-adverse party, and/or] the trustee, who must be a non-adverse party." The document would then need to include provisions to enable appointment of a non-adverse party as trustee if, for instance, the spouse was a trustee. If a non-adverse party is named, it would be prudent to name alternates in the event the first is deceased or incapacitated.27

Moreover, a GPOA is "considered to exist on the date of a decedent's death even though the exercise of the power is subject to the precedent giving of notice, or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the decedent's death notice has been given or the power has been exercised." Treas. Reg. § 20.2041-3(b). Including these sorts of requirements would make GPOAs more difficult to actually exercise, yet still come within the safe harbor of a Treasury regulation.

5. Exposure to Creditors. Does granting a surviving spouse a testamentary power to appoint trust property to the creditors of his or her estate mean that those creditors can reach the trust property even if the property is not so appointed? The answer will depend upon local law. For example, it would not appear so in Texas. The spendthrift provisions of the Texas Trust Code generally allow a grantor to provide by language in the trust agreement that the interest of a beneficiary in the income or in the principal of the

27 The use of a non-adverse party in this context should be contrasted with the problems under Code Section 2041(b)(1)(C) discussed beginning at page 33 above regarding naming a third party with the right to grant the spouse a general power of appointment. In the present context, the spouse already holds the optimum power; the requirement of consent from a third party is included only to make it harder for the spouse to actually exercise the power in a manner inconsistent with the grantor’s wishes.
trust, or in both, may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. TEX. PROP. CODE § 112.035. While in most cases, the spendthrift provisions do not apply to trusts of which the grantor of the trust is also a beneficiary, Texas law provides that a beneficiary of the trust may not be considered to be a grantor, to have made a voluntary or involuntary transfer of the beneficiary's interest in the trust, merely because the beneficiary, in any capacity, holds or exercises a testamentary power of appointment. Id. at (f)(2). This rule is in contrast to the exposure of a presently exercisable general power, which is discussed below. In Texas, there are certain circumstances where the initial grantor may end up being a later beneficiary of a spendthrift trust, and the trust will maintain its spendthrift protections as to all beneficiaries, including the now grantor-beneficiary. Namely, if a spouse establishes a trust for his spouse and at the spouse's death, the donor spouse becomes a beneficiary of the trust, or if a grantor establishes a trust for someone else and either the trust property was subject to a general power of appointment held by someone else or if the property later passes back in trust for the benefit of the grantor as the result of someone else's exercise of a limited power of appointment over the trust property, the trust will maintain its spendthrift protections. Id. at (d), (g).

C. Using the Delaware Tax Trap Instead of a GPOA to Optimize Basis

A power of appointment that the power holder cannot exercise in favor of him- or herself, his or her creditors, his or her estate, or the creditors of his or her estate, is known as a "special" or "limited" power of appointment. Normally, holding or exercising a limited testamentary power of appointment over property does not cause that property to be included in the power holder's estate for federal estate tax purposes. IRC § 2041(b)(1)(A). However, estate tax inclusion does result if the power is exercised:

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.

IRC § 2041(a)(3). Exercising a limited power of appointment in this manner triggers the so-called "Delaware Tax Trap" ("DTT"). If the surviving spouse exercises the power in this fashion, the property so appointed is includable in the surviving spouse's estate for federal estate tax purposes, and therefore receives a new cost basis upon the death of the surviving spouse. IRC § 1014(b)(9). As indicated above, an OBIT may be designed to grant a carefully tailored GPOA to the surviving spouse to achieve optimum basis increase. But what if your client does not want to grant his or her spouse a general power of appointment, no matter how narrowly drawn? Or what if you are dealing with an existing funded bypass trust that lacks such a formula power? The Delaware Tax Trap can be used to accomplish the same result with a limited power of appointment. The technique involves the affirmative use of what has previously been perceived as a tax "pitfall" in the rules involving the exercise of limited powers of appointment.

1. General Principles. While applying the DTT to specific situations can be somewhat complex, the statutory language noted above is relatively straightforward. The statute causes property to be included in the power holder's estate, even if the power holder has only a limited power of appointment, if it is actually exercised by appointing property and granting a new power of appointment in a way that restarts the running of the Rule Against Perpetuities without regard to the date that the original power of appointment was created. Specifically, the DTT is "sprung" when (i) someone exercises a power of appointment (ii) to create a second power of appointment that (iii) under applicable law can be validly exercised to (iv) postpone the vesting of an estate or interest in property (or suspend the absolute ownership or power of alienation of property) (v) for a period not ascertainable without regard to the date of the

28 Whether a power of appointment is testamentary or a lifetime (presently exercisable) GPOA also makes a difference in bankruptcy. See 11 USC § 541(a)(1), (b)(1), (c).

29 See also Treas. Reg. § 20.2041-3(e). There is a gift tax analog, IRC § 2514(e), but triggering gift tax typically only increases basis to the extent of gift tax actually paid, so its application is extremely limited.
exercise of the first power. If exercising a limited power of appointment (usually thought of as "safe" for estate tax purposes) in a way that restarts the Rule Against Perpetuities might cause inadvertent estate tax inclusion, many states have enacted "savings clauses" into their statutes that restrict the ability of the holder of a limited power to trigger the trap in most instances. In addition, some estate planning attorneys have drafted tightly drawn Rule Against Perpetuities savings clauses in wills or trust agreements that prevent limited powers of appointment from being exercised in a way to trigger the trap. If the drafting language does not prevent triggering the trap, then despite most state law restrictions, there is usually one method left out of state savings statutes that appears to be available in most states.

2. Granting a PEG Power. Specifically, if the surviving spouse holds a limited power of appointment which permits appointment in further trust, and the surviving spouse appoints trust assets into a separate trust which gives a beneficiary a presently exercisable general power of appointment (sometimes referred to as a "PEG power"), the appointment would, under common law, reset the "clock" on the running of the Rule Against Perpetuities. See RESTATEMENT (THIRD) OF TRUSTS § 56 cmt. b. This exercise thereby "postpones the vesting" for a period "ascertainable without regard to the date of the creation of [the spouse's limited] power." The effect of postponing vesting is to trigger Code Section 2041(a)(3), causing the appointed property to be included in the surviving spouse's estate for federal estate tax purposes. Estate tax inclusion results in an adjustment to the basis of the property under Code Section 1014(b)(9).

Might an argument be made that in order to trigger estate tax inclusion, the power must be exercised in favor of someone other than the person who would receive the property in default of the exercise? Fortunately, Treasury regulations make it clear that is not the case. Treasury Regulation Section 20.2041-1(d) provides: ". . . 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."

3. Gaining a Step-Up. Issues associated with springing the DTT could themselves be the subject of an entire seminar, but suffice it to say that under common law, for the surviving spouse to exercise the power of appointment in order to cause estate tax inclusion, he or she must effectively grant someone a presently exercisable general power of appointment. Thus, for example, the surviving spouse could appoint low-basis bypass trust property into trusts for his or her children which then grant the children inter vivos general powers of appointment. The exercise of a limited power of appointment in this manner would permit the children to appoint the property in further trust, restarting the applicable Rule Against Perpetuities. As a result, the exercise of the limited power of appointment would generate a step-up in basis at the surviving spouse's death under Section 1014(b)(9) of the Code. As mentioned above, Code Section 1014(b)(9) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent prior to the decedent's death. As a result, if an exercise of the power causes depreciable property to pass to a

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31 See, e.g., CONN. GEN. STAT. § 45a-492; N.J. REV. STAT. § 46.2F-10(a)(3); N.Y. EST. POWERS & TRUST LAW § 10-8.1(a). For a survey of state law provisions, see Zaritsky, The Rule Against Perpetuities: A Survey of State (and D.C.) Law, pp. 8-10 available at: tinyurl.com/zwomagt. See also Blattmachr and Pennell, Using the Delaware Tax Trap to Avoid Generation Skipping Transfer Taxes, 68 J. OF TAXN 242 (1988); Blattmachr and Pennell, Adventures in Generation-Skipping, or How We Learned to Love the Delaware Tax Trap, 24 REAL PROP. PROB. & TR. J. 75 (1989). While the cited articles do not discuss using the DTT for basis planning, the discussion is nevertheless helpful. For a more current discussion, see Nenno, fn. 30; Spica, A Practical Look at Springing the Delaware Tax Trap to Avert Generation Skipping Transfer Tax, 41 RPTL J., 167 (Spring 2006); Greer, The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities, 28 EST. PLAN. 2 (2001); Culler, Revising the RAP, PROB. L.J. OHIO (Mar./Apr. 2012).
32 Somewhat ironically, Delaware amended its Rule Against Perpetuities statute to preclude use of the Delaware Tax Trap, including for trusts with a zero inclusion ratio for GST tax purposes, which would include most bypass trusts. 25 DEL. CODE §§ 501, 503, 504(a). A recent amendment to Delaware law, however, now once again allows the trap to be used for trusts with a zero inclusion ratio for GST tax purposes, if done so explicitly. Id. §§ 504(b), 505.
33 Treas. Reg. § 20.2041-3(e)(2).
taxpayer that has been entitled to claim depreciation on the appointed property, the basis adjustment may be limited.

4. **Drafting to Enable Use of the DTT.** The use of the DTT strategy does not require any particularly complex drafting in the bypass trust. It should be sufficient that the trust grants the surviving spouse a limited testamentary power of appointment, and that any Rule Against Perpetuities savings clause in the will does not prevent exercising that power in a manner that restarts the Rule. The surviving spouse will need to draft a will that exercises the power in a manner that restarts the Rule, either by expressly exercising it over specific assets whose combination of basis increase and value create favorable tax results, or by exercising it in a formula manner to achieve optimal basis adjustment results. The cascading asset-by-asset formula approach described above beginning on page 36 with regard to formula GPOAs could be adapted to cause this result. Sample language providing for a formula exercise of the Delaware Tax Trap is included as Exhibit E.

5. **Costs of Using the DTT.** Granting a beneficiary a PEG power impairs asset protection much more than does granting a testamentary power. In most states, the creditor of someone holding only a testamentary power of appointment cannot attach trust assets, even upon the death of a beneficiary. In contrast, if the beneficiary holds an inter vivos general power of appointment, exposure of trust assets to a beneficiary's creditors is not generally limited by spendthrift language. See, e.g., UNIF. TRUST CODE § 505(b)(1) (2010); RESTATEMENT (THIRD) OF TRUSTS § 74(2) (equating holder of PEG power with grantor of revocable trust). When a PEG power is granted, a beneficiary's creditors can reach any of the trust's assets at any time. In addition, a PEG power may preclude shifting taxable income to other trust beneficiaries, because the existence of a presently exercisable general power generally causes the trust to be treated as a grantor trust as to the power holder—the trust's income is taxed to the holder of the power if he or she has the power to appoint trust income to him- or herself, exercisable solely by him- or herself. IRC § 678. Moreover, the PEG power prevents the beneficiary from making gift-tax-free distributions of trust property to other trust beneficiaries, and results in state and federal estate taxation inclusion (and a possible step-down in basis) at the time of the power holder's death. IRC §§ 1014(b)(4), 2041. These disadvantages may make using the DTT to harvest a basis adjustment an unattractive tool, especially for clients who wish to use lifetime trusts for their children's inheritance. The "price" of new cost basis when the surviving spouse dies is creditor exposure and estate tax inclusion for the person to whom the PEG power is granted. It may, however, be the only tool available (if a somewhat unpalatable one) in the context of preexisting irrevocable trusts that already contain limited powers of appointment. And if the existing bypass trust terminates in favor of children outright anyway, and no disclaimer funding is anticipated, this route may be the easiest and most flexible to take, since outright ownership by the children has all of the same shortcomings as does granting them a PEG power. Note that if the bypass trust in question arose by virtue of the surviving spouse's disclaimer of assets, the DTT would not be available. As noted above, a "disclaimer bypass" trust generally precludes (or at least markedly limits) the spouse from retaining a limited power of appointment which is necessary to "spring" the DTT.

6. **Mitigating the Costs.** If the spouse wishes to preserve creditor protections for the children, he or she could presumably appoint the assets into trust for them, but grant some other party the PEG power. Note, though, that whomever holds the power would have estate tax inclusion of the assets subject to the power (or would be treated as having made a gift if the power were released), and the assets would be subject to the claims of that person's creditors. So long as the person holding the PEG power has applicable exclusion amount (and GST tax exemption) to spare, however, the property could continue in GST tax-exempt creditor-protected trusts for the children.

**Example 13:** W died many years ago with a Will that created a bypass trust for H, granting H a testamentary limited power to appoint property outright or in trust for H and W's children. In default of H's exercise of his power of appointment, the property passes into lifetime spendthrift trusts for the children that would be exempt from estate tax upon the children's death, and exempt from the GST tax when property passes to grandchildren. The bypass trust holds low basis stock, the fair market value of which, when added to the value of H's other assets, does not exceed H's applicable exclusion amount. H in his Will appoints the stock into new trusts for the benefit of his children, identical to the trusts created in W's Will, except that H's younger sister S is granted a PEG power over the trusts, and the Rule Against Perpetuities for the
new trusts begins to run at the time of H's death. S's estate, including the projected value of the stock, is expected to be well below her applicable exclusion amount. Upon H's death, the stock so appointed is included in H's estate under Code Section 2041(b)(1)(A), and as a result, it receives a new cost basis at the time of H's death under Code Section 1014(b)(9). H's GST exemption may be allocated (or may be deemed allocated) to the trusts. Upon S's later death, the stock is included in her estate under Code Section 2041(a)(2), and receives another basis adjustment under Code Section 1014(b)(4). S's GST exemption may be allocated (or may be deemed allocated) to the trusts. The children's trusts thus inherit the stock with an adjusted basis, but without exposing it to the children's creditors, or to estate or GST tax upon the children's death.

7. **State Law "Fixes."** If PEG powers are granted to children or other descendants in order to "spring" the DTT, they might cause the next generation to obtain a new cost basis at the expense of forgoing asset protection, income shifting, and GST tax exemption. These difficulties could be avoided if states would amend their Rule Against Perpetuities statutes (or their statutes governing powers of appointment) to permit the exercise of limited powers of appointment to restart the Rule Against Perpetuities by creating further *limited* powers, instead of PEG powers, while expressly declaring an intention to thereby trigger the DTT. For example, Arizona's Rule Against Perpetuities apparently permits such an exercise.34

D. **Is the DTT Safer than a Formula GPOA?**

Some practitioners may prefer using the Delaware Tax Trap for another reason altogether. They may fear that if a formula GPOA is given to a surviving spouse, the spouse's ability to control the value of his or her own net taxable estate value (either through spending, or by leaving assets to charity or new spouse), may permit indirect control of the value of the assets in the bypass trust subject to the formula GPOA. If that argument were to prevail, the IRS might seek to include all of the bypass trust assets in the surviving spouse's estate, and not just the "optimum" amount. Proponents of the formula GPOA approach note that formula funding clauses based on a surviving spouse's available GST tax exemption amount have been used for decades without giving rise to this argument by the IRS.35 However, there is some plausibility to the argument.

1. **Estate of Kurz.** With regard to this issue, the *Estate of Kurz v. Commissioner*, 101 TC 44 (1993), aff'd 68 F3d 1027 (7th Cir. 1995) is instructive. In Kurz, the husband's estate plan provided for a marital trust that gave his wife an unrestricted lifetime GPOA. The bypass trust provided that if the marital trust was exhausted, the wife also had a lifetime 5% withdrawal power over the bypass trust. Upon the wife's death, the IRS argued that not only was the marital trust included in the wife's estate, but that 5% of the bypass trust was also included. The estate argued that the 5% was not in the estate because the marital trust had not been exhausted by the time of the wife's death, so the condition precedent to her 5% withdrawal right had not been met.

The IRS contended that all the wife needed to do to obtain 5% of the bypass trust assets was to withdraw or appoint the assets in the marital trust. Both the Tax Court and the appellate court agreed with the IRS, concluding that the wife held a GPOA over 5% of the bypass trust's assets since she could effectively withdraw the 5% at any time during her lifetime, for any reason, without affecting her estate.

The Tax Court's rationale was that the condition precedent cited by the estate 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 the time of her death. It looked to examples in the relevant Treasury regulations and noted that the examples of contingencies which precluded inclusion were not easily or quickly controlled by the power holder.

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34 ARIZ. REV. STAT. § 14-2905 C. See Raatz, 'Delaware Tax Trap' Opens Door to Higher Basis for Trust Assets, 41 EST. PLAN. 2 (2014). Mr. Raatz, an attorney from Phoenix, Arizona, has argued that the same opportunity may be available in any state that has adopted the Uniform Statutory Rule Against Perpetuities.

35 See Morrow, fn. 22.
2. **Impact of Kurz.** Interestingly, both sides of the debate on formula GPOA clauses cite Kurz. Opponents note that the amount of the formula GPOA in the bypass trust is conditioned upon the size of the surviving spouse's taxable estate, and since the surviving spouse has the ability to control that (through lifetime or testamentary charitable or marital gifts, or through consumption of his or her assets), the amount of the property subject to the formula GPOA is likewise in his or her control. Proponents of formula GPOA clauses (like OBIT advocate Morrow) note that the typical formula GPOA clause is not a lifetime GPOA.

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) [regarding conditional powers of appointment]—it is pursuant to other treasury regulations cited herein [specifically, Treas. Reg. § 20.2041-1(b)(3): Powers over a portion of property]. 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.36

Until greater certainty is provided on the issues, whether by the IRS or the courts, some practitioners may prefer avoiding even the hint of a Kurz-type argument against formula GPOA caps. The more conservative approach would be to require the GPOA formula to be applied, ignoring any charitable or marital deduction otherwise available to the surviving spouse's estate.37 In most cases and estate plans, surviving spouses are unlikely to be making large charitable or marital gifts, so formulae that require one to ignore these adjustments is unlikely to make much, if any, difference in the use or availability of the GPOA.

Unlike a formula GPOA, the Delaware Tax Trap is only applicable to the extent that the surviving spouse affirmatively exercises his or her limited power of appointment ("LPOA") to trigger the trap. There is no danger of the mere existence of an LPOA (or a lapse of an LPOA) causing inclusion under Code Section 2041(a)(3) just because the surviving spouse has the authority to exercise it. Therefore, using the Delaware Tax Trap technique is immune from Kurz-type arguments. As a result, many attorneys may prefer it.

E. **Other Strategies for Basis Adjustment.**

1. **Transmuting Separate Property into Community Property or Vice Versa.** As noted earlier, a basis adjustment at death applies not only to the decedent's interest in community property but also to property which represents the surviving spouse's one-half share of community property. IRC § 1014(b)(6). Therefore, a strategy to obtain an increase in basis may be to transmute (i.e., convert) low-basis separate property into community property. Doing so ensures that no matter the order the spouses' deaths may occur, the surviving spouse will receive a new cost basis in all of the property. On the other hand, a few cautions to this strategy are necessary. If property is transmuted, all or part of the separate property being converted to community property may become subject to the liabilities of both spouses. In addition, all or part of the separate property being converted to community property may become subject to the joint management, control, and disposition of both spouses or the sole management, control, and disposition of the other spouse alone. Finally, of course, if the marriage is subsequently terminated by the death of either spouse or by divorce, all or part of the separate property being converted to community property may become the sole property of the spouse or the spouse's heirs. Don't forget to consider the converse strategy for depreciated community property assets. If it appears that one spouse may have a shortened life expectancy and death may result in a loss of basis, consider partitioning the depreciated property into separate property (or as discussed below, giving the depreciated property to the healthy spouse). Doing so will avoid the loss in basis at the first spouse's death to the extent of the surviving spouse's separate interest in the property.

36 Morrow, fn. 22.
2. Transferring Low Basis Assets to the Taxpayer. Since assets owned by an individual may receive a new cost basis at death, taxpayers may consider transferring low basis assets to a person with a shortened life expectancy, especially if the person will return the property at death by will or other arrangement. This basis "gaming" may be easier in an environment with substantial estate and gift tax exemptions, since those exemptions may be used to avoid transfer tax on both the gift and the subsequent inheritance. If the person to whom the assets are initially transferred does not have a taxable estate, substantial additional assets may be transferred, and a new basis obtained, without exposure to estate tax. While transfers among family members may involve taxable gifts, transfers between spouses do not give rise to gift tax exposure, regardless of amount, if the donee spouse is a U.S. citizen. IRC § 2056.

a. Gifts Prior to Death. One gifting strategy involves transferring property that has appreciated in value to a less healthy (or even terminally ill) family member with the expectation that it will receive a favorable basis adjustment at death. Note that if obtaining a basis increase is the goal, Congress is aware that someone could acquire an artificial step-up in basis by giving property to a terminally ill person, and receiving it back with a new basis upon that person's death. As a result, the Code prohibits a step-up in basis for appreciated property given to a decedent within one year of death, that then passes from the decedent back to the donor (or to the spouse of the donor) as a result of the decedent's death. IRC § 1014(e). If the property passes back to the donor or the donor's spouse at death, a new basis is achieved only if the taxpayer lives for at least one year after receipt of the property. One might also consider the opposite strategy for gifts of depreciated assets by an unhealthy (or terminally ill) family member before death with a goal of avoiding a step-down in basis. By making such a gift of depreciated property, when the donee later sells the property, gain recognition by the donee is minimized to the extent of the donor's basis since the carryover basis rules would apply to the gifted property. There is no one-year rule to contend with this strategy is employed.

b. Granting a General Power. Rather than giving property to a terminally ill individual, suppose that you simply grant that person a general power of appointment over the property. For example, H could create a revocable trust, funded with low basis assets, and grant W a general power of appointment over the assets in the trust. The general power of appointment will cause the property in the trust to be included in W's estate under Section 2041(a)(2) of the Code. In that event, the property should receive a new cost basis upon W's death. IRC § 1014(b)(9). The IRS takes the position that the principles of Section 1014(e) apply in this circumstance if H reacquires the property, due either to the exercise or non-exercise of the power by W. See PLR 200101021 ("Section 1014(e) will apply to any Trust property includible in the deceased Grantor's gross estate that is attributable to the surviving Grantor's contribution to Trust and that is acquired by the surviving Grantor, either directly or indirectly, pursuant to the deceased Grantor's exercise, or failure to exercise, the general power of appointment", citing H.R. Rept. 97 201, 97th Cong., 1st Sess. (July 24, 1981)). If W were to actually exercise the power in favor of (or the taker in default was) another taxpayer, such as a bypass-style trust for H and their descendants, the result should be different.

3. Transferring High Basis Assets to Grantor Trust. An intentionally defective grantor trust, or "IDGT," is one in which the grantor of the trust is treated as the owner of the trust property for federal income tax purposes, but not for gift or estate tax purposes. If the taxpayer created an IDGT during his or her lifetime, he or she may consider transferring high basis assets to that trust, in exchange for low basis assets of the same value owned by the trust. The grantor trust status should prevent the exchange of these assets during the grantor's lifetime from being treated as a sale or exchange for federal income tax purposes. Rev. Rul. 85-13, 1985-1 CB 184. The effect of the exchange, however, will be to place low basis assets into the grantor's estate, providing an opportunity to receive a step-up in basis of those assets at death. But for the exchange of these assets, the low basis assets formerly held by the trust would not have acquired a step-up in basis as a result of the grantor's death. At the same time, if the grantor transfers assets with a basis in excess of fair market value to the trust, those assets will avoid being subject to a step-down in basis at death. Since the grantor is treated for income tax purposes as the owner of all of the assets prior to death, the one-year look-back of Section 1014(e) of the Code should not apply to limit the step-up in basis of the exchanged assets.

4. Capturing Capital Losses. If a terminally ill individual has incurred capital gains during the year, he or she may consider disposing of high basis assets at a loss during his or her lifetime, in order
to recognize capital losses to shelter any gains already incurred during the year. As noted earlier, assets the basis of which exceed their fair market value receive a reduced basis at death, foreclosing recognition of these built-in capital losses after death. Moreover, losses recognized by the estate after death will not be available to shelter capital gains recognized by the individual before death. If, on the other hand, the individual has recognized net capital losses, he or she may sell appreciated assets before death with impunity. Net capital losses are not carried forward to the individual's estate after death, and as a result, they are simply lost. Rev. Rul. 74-175, 1974-1 CB 52.

VI. WHAT WORKS NOW?

Given the substantial and presumably permanent changes in estate and gift tax exemptions, the availability of portability, and the increase in income tax rates, estate planners are wrestling with the traditional tools in their tool box to try to decide which are still well suited to address clients' goals. At the same time, they are evaluating new ideas (or re-evaluating old ideas) in view of this new paradigm. So what works now?

A. Intra-Family Loans

One of the most attractive wealth-transfer strategies is also one of the simplest—a family loan.38 The IRS permits relatives to lend money to one another at the "Applicable Federal Rate," which the IRS sets monthly. Even with good credit, it has become increasingly frustrating for people to qualify for bank loans. With an intra-family loan, relatives can charge far less than a bank. For example, at the end of June, 2017, when Bankrate.com quoted the rate on a 30-year mortgage at around 3.8%, the Applicable Federal Rate for July ranged from 1.22% to 2.60%, depending on the loan's term.

The Technique. With banks tightening credit standards, the appeal of The Bank of Mom & Dad is obvious. These loans and their super-low interest rates are also great estate-planning opportunities. If the borrower (say, a child) invests the loan's proceeds wisely, he or she will have something left over after repaying the lender (say, Mom). This net gain acts like a tax-free gift to the borrower.

Example 14: In July, 2017, Mom loans $400,000 to her daughter and son-in-law to purchase a home. Mom structures the loan with a thirty-year amortization, but with a balloon payment due at the end of nine years. Because the couple was able to lock in an interest rate of just 1.89% over the next nine years instead of the 3.8% offered by their bank, the couple will save more than $7,600 in interest costs the first year alone, while reducing their monthly payments by approximately $407 from $1,863 to $1,456. The young couple will profit as long as the home appreciates by more than the modest cost of interest. To further reduce the cost of the loan, and put even more potential profits in her kids' pockets, Mom might use another estate-planning technique. She and her husband can use the $14,000 each is able to give tax-free to their daughter and son-in-law every year to pay down the loan's principal. (See "Outright Gifting," below). By reducing the size of the loan, this tactic would slash the total amount of interest the young couple will owe on this debt. By helping the couple retire its $400,000 debt to her, Mom will also reduce her estate by as much as $400,000— that could cut her estate tax bill by $160,000.

Specifics.

1. Section 7872 Loans. Family loans are governed by Code Section 7872. However, this section of the Code generally deals with interest-free or "below-market" loans between related taxpayers—not the type of loan described above. For family loans, Section 7872 provides that a below-market loan will be treated as a gift loan, resulting in the imputation of a gift from the lender to the borrower in an amount equal to the forgone interest. In addition, a below-market loan results in a deemed payment of interest by the borrower to the lender for income tax purposes. Section 7872 not only spells out the consequences of a "below-market" loan, but also describes how to avoid one. It requires the IRS to set the "market" rate for loans each month. As long as the family charges the rate set out by the IRS, the "imputed interest" rules of Section 7872 are avoided. With IRS interest rates at historically low levels, there is no

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38 For a thorough discussion of this subject, see Akers and Hayes, Estate Planning Issues with Intra-Family Loans and Notes, 42nd ANN. NOTRE DAME TAX AND EST. PL. INST. (2016).
need for families to make "below-market" loans and incur the harsh results. A loan at the market rate set by the IRS works just fine.

2. Term Loans. A term loan will not be treated as a gift loan as long as the interest rate applicable to the term loan equals or exceeds the Applicable Federal Rate ("AFR") promulgated by the IRS as of the day on which the loan was made, compounded semi-annually. IRC § 7872(f)(2). The interest rate depends on the term of the note. For a promissory note with a maturity of three years or less, the federal short-term rate must be used. For a promissory note with a maturity in excess of three years but not more than nine years, the federal mid-term rate must be used. For a promissory note with a maturity of nine years or more, the federal long-term rate must be used. These rates are the floor used to avoid any adverse federal income and gift tax results. IRC § 7872(e).

3. Demand Loans. A demand loan will not be treated as a gift loan, provided that the interest rate applicable to the demand loan is at least equal to the short-term Applicable Federal Rate for the period in which the loan is outstanding, compounded semi-annually. IRC § 7872(f)(2).

4. Note Terms. With regard to a term loan, to ensure that the IRS will respect the validity of the loan, the note evidencing the loan should contain a fixed maturity date, a written repayment schedule, a provision requiring periodic payments of principal and interest, and a provision regarding collateral. Est. of Lockett v. Comm'r, TC Memo 2012-123. In other words, the loan should be treated like any other typical third-party financing. In addition, actual payments on the note should be made from the junior family member to the senior family member. For demand notes, if the senior family member never demands payments or if the junior family member does not have the ability to satisfy the loan, and if repayment is never expected, an inference can be made that the senior family member never intended the loan to be repaid. Conceivably, if the parties do not respect the note, the IRS could seek to reclassify the transfer of the loan proceeds from the senior family member to the junior family member as a taxable gift as of the date of the loan. See Est. of Lillie Rosen v. Comm'r, TC Memo 2006-115. Regardless of the type of loan, the junior family member should "qualify" for the loan. Factors considered in Rosen included the inability of the note holder to make payments on the note, the fact that the payee had no reasonable expectation of repayment by the maker of the note, and that no payments were ever made during life. Id. As mentioned in the example above, while the senior family members might use their annual exclusion amount to forgive payments on the note, there should be no plan or agreement in this regard, or again, the IRS may seek to reclassify the note as a gift.

5. Impact of Interest Rates. If the property acquired with funds loaned from the senior family member to the junior family member appreciates at a rate greater than the prevailing interest rate and/or earns income in excess of the prevailing interest rate, then the loan effectively shifts value estate-tax free from one generation to the next.

6. Income Tax Issues. Tax implications for family loans must include consideration of federal (and state) income taxes on senior and junior family members. More specifically, the senior family member will generally have interest income to recognize as part of his or her taxable income, but the junior family member will generally not be able to deduct the interest paid from his or her taxable income unless the interest constitutes investment interest or home mortgage interest to the borrower. IRC § 163(h). As long as the senior family member is not in the business of making loans, there is no reporting requirement for federal income tax purposes regarding the interest payments. IRC § 6041(a).

7. Death During Term. If the lender dies during the term of the loan, any unpaid balance will generally be included in the taxable estate of the lender. Treas. Reg. § 20.2031-4. Note, however, that the value of the note is generally limited to the value of the collateral and the net worth of the borrower, without regard to any amount the borrower might inherit. See Est. of Elizabeth V. Harper, 11 TC 717 (1948), acq., 1949-1 CB 2; TAM 9240003 ($215,000 note owed to estate of uncle by insolvent nephew properly valued at substantially less than face value despite testamentary forgiveness of debt and $1 million bequest to nephew from uncle). If the junior family member has paid back any portion of the loan, the repaid funds will likewise be included in the lender's estate if not otherwise spent. It is the return in excess of the IRS interest rate that the junior family member earns by investing the principal of the loan that escapes estate taxation. Of course, as discussed above, the senior family members may use their gift tax annual
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exclusion to reduce the outstanding principal balance, thereby reducing estate inclusion at the time of their deaths, as long as there is no pre-arranged plan to do so. Keep in mind that the IRS and Treasury's Priority Guidance Plan for 2016-2017 (released October 31, 2016) includes guidance on valuation of promissory notes under Sections 2031, 2033, 2512, and 7872 as an item on its project list, the result of which (if any) could impact the valuation of the note at the lender's death.

8. **Use with Grantor Trusts.** To ameliorate the impact of income taxes, instead of a loan from senior family members to junior family members, senior family members could create an "intentionally defective" grantor trust or "IDGT" for the benefit of junior family members and make a loan to the grantor trust. (IDGTs are discussed in more detail beginning at page 52 below.)

   a. **Borrower's Credit-Worthiness.** If a senior family member wants to loan money to a grantor trust, the grantor trust should be "seeded" with sufficient assets to make the trust a credit-worthy borrower (most commentators suggest a 10% seed-money gift but no official guidance exists to confirm the amount). Without this equity, the IRS might doubt the trust's ability to repay the loan, especially if the trustee invests the loan proceeds in illiquid or volatile investments. If the loan can't be repaid, the IRS might instead treat it as a gift.

   b. **Other Aspects.** It may be advisable for the grantor trust to be structured as a so-called "perpetual" or "dynasty" trust for the senior family member's descendants, giving the trustee broad discretion to make distributions, rather than mandating any distributions. These trusts have substantial non-tax benefits. For example, if the descendants have problems with creditors, the creditors can attach assets that are distributed to them outright. In contrast, trust assets are generally exempt from attachment as long as the trust has "spendthrift" language. Similarly, a spouse of a descendant may become a creditor in a divorce situation. In community property jurisdictions, outright distributions that are commingled with a spouse could be classified as community property, subject to division by a divorce court. Keep in mind that even a spendthrift trust may not be exempt from all obligations of a beneficiary. See, e.g., TEX. FAM. CODE § 154.005 (court may order trustee of spendthrift trust to make disbursements for child support obligation of beneficiary if trustee is required to make distributions to beneficiary; if distributions are discretionary, court may order child support payments from income but not principal). Properly maintained trust assets cannot be commingled. Also, outright distributions may allow assets to be given away to individuals outside of the senior family member's bloodline. With a trust, the senior generation can choose to put limits on the people that will benefit from the gift. In addition, upon the death of a beneficiary, if an outright distribution is made, the beneficiary's share would be included in his or her gross estate for federal estate tax purposes. If, however, the grantor trust is exempt from the generation-skipping transfer tax (i.e., the senior family member's available GST tax exemption is allocated to the grantor trust), these assets can remain in trust and pass to trusts for even more junior family members without being subject to estate or GST tax.

9. **Rates and Yield Curves.** Although short-term interest rates are normally lower than the mid-term and long-term rates, there are times when the mid-term interest rates and the long-term interest rates are less than the short-term interest rates. Furthermore, there are periods of time where the spread between short-term rates and long-term rates is minimal. As a result, it can be advantageous to try to time the loans to coincide with favorable interest rates. The IRS generally publishes rates for the following month about ten days in advance. So, for example, the IRS published the July, 2017 rates on June 16th. Therefore, near the end of a month, planners can preview upcoming rates to time a transaction to take advantage of the most favorable rates.
10. **Current Rates.** The current annual interest rates (for July, 2017) are as follows:
   
a. Short-term annual interest rate – 1.22%
   
b. Mid-term annual interest rate – 2.89%
   
c. Long-term annual interest rate – 2.60%


11. **Using a Balloon Note.** As long as the interest rate on the note is less than the return earned by the borrower, it may make sense to maximize the loan for as long as possible. The more principal that is paid back during the term of the note, the less wealth transfer potential there is from senior family members to junior family members. As a result, it may be better to draft the note to provide for the payment of interest only during its term, with principal due only at maturity. While the unpaid principal balance will be included in the lender's estate if he or she dies before the loan is repaid, a note providing for interest-only payments lets junior family members use funds as long as possible (and may provide more of an opportunity for senior family members to reduce the principal balance through annual exclusion gifts, if they choose to do so). Keep in mind that this structure is more aggressive than the typical loan format.

12. **Payment at Maturity.** Upon maturity, junior family members can either repay the loan or renegotiate the terms of the note. If interest rates decline during the term of the note, or if they are lower at maturity, it may be possible to renegotiate at a time when interest rates are favorable. To allow for this option, the promissory note should contain a provision which allows the outstanding principal balance to be repaid at any time without any penalty. Some commentators caution, however, that the loan should not be renegotiated too frequently, since doing so may appear to be gratuitous rather than part of a business transaction.

**B. Outright Gifting**

Outright gifts lack the sizzle and sophistication of the alphabet soup of more exotic techniques. Simple annual exclusion gifts, however, can have a dramatic impact on wealth shifting over time. For clients willing to pay a current gift tax or use a portion of their lifetime gift tax exemptions, the results can be impressive. The impact of gifting can be even more impressive when the value of the assets given are depressed, and when the number of donees is large. Outright qualified transfers for payment of tuition or medical expenses are described below in the discussion of HEETs.

**The Technique.** Outright gifts can be as simple as handing cash or writing a check to the donee. Gifts can take the form of stock, real estate (or undivided interests in real estate), life insurance policies, or family limited partnership interests. Gifts to minors can be placed into custodial accounts (although to ensure that the assets are not included in the donor's estate if he or she dies before the donee reaches age 21, the donor should not serve as custodian). Section 529 plans offer another opportunity for gifting to minors, although gifts to Section 529 plans must take the form of cash. For clients that expect to pay estate tax at death, even taxable gifts may make sense, since the gift tax is tax exclusive (i.e., it is based upon the net amount received by the donee), whereas the estate tax is tax inclusive (i.e., all dollars are subject to the estate tax, including the dollars used to pay the tax). It is important to remember that for estate tax reporting, adjusted taxable gifts are added back in as part of calculating the gross estate tax. IRC § 2001(b).

**Example 15:** Gary and Gwen have four married children and seven grandchildren. In March, 2009, they decide to make gifts to their children, in-laws and grandchildren using their annual gift tax exclusion ($13,000 in 2009). With four children, their four spouses, and seven grandchildren, Gary and Gwen can each make 15 annual exclusion gifts, for a total of $390,000. Gifts to the grandchildren are placed into custodial accounts, with a parent of each grandchild serving as custodian. In this case, each donee used the funds received to buy a Dow Jones index fund when the average stood at about 6,700. With the Dow now

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trading near 21,000, the current value of assets transferred out of Gary and Gwen's estate could be over $1.2 million.

**Example 16:** Dave has a large estate well in excess of any funds he will spend during his lifetime. He has used all of his gift tax exemption, and plans to transfer $12 million to his children either now or when he passes away. If he waits until his death, the tax on $12 million will be $4,800,000, (40% of $12 million) leaving $7,200,000 for his children. If Dave makes the gift today, he could give the kids $8,571,429, in which case the gift tax (ignoring annual exclusions) would be $3,428,571 (40% of $8,571,429), fully exhausting Dave's $12 million. Assuming that Dave lives for at least three years after the gift, the net result is an additional $1,371,429 to the children. While Dave will have to pay the gift tax next April 15th instead of waiting to pay the estate tax at death, the kids will have the $8.57 million, plus growth during Dave's lifetime, without any additional gift or estate tax.

**Specifics.**

1. **What to Give.** Despite the basis issues discussed below (and above), estate planners generally recommend making outright gifts when market conditions are depressed–sometimes called "natural discounting" (i.e., making gifts of stock when the stock market takes a significant downturn, or gifts of real estate when the real estate market is depressed). As mentioned above, post-gift appreciation lands in the junior generation's hands with no gift or estate tax. In the first example above, if Gary and Gwen consistently make gifts within the annual exclusion amount for 10 years, and if the donees invest the funds only at 5% per annum, Gary and Gwen could move over $5.1 million from their estates with no gift or estate tax. In the second example above, even if no additional gifting were done, if Dave's kids invested the gifted property at 5% per annum for ten years, the property would grow to nearly $14 million. All of this growth would be removed from the senior family member's estate and pass to the junior family members, free of gift and estate tax. Another ideal candidate for gifting to younger-generation family members (or to a trust for their benefit) is life insurance, which in virtually all cases will have a value for gift tax purposes lower (and in many cases significantly lower) than the value of the death benefit paid upon the death of the insured. Once ownership of the life insurance policy is changed, the insured can make ongoing gifts of cash to the new owner to enable the owner to pay life insurance premiums as they come due. The almost automatic benefit of shifting life insurance death benefits out of one's estate at a low gift tax cost has caused Congress to impose a three-year "wait" on the effectiveness of this strategy. That is, if there is a transfer of an existing life insurance policy owned by the insured, and the insured dies within three years of the transfer, the insurance proceeds are nevertheless included in the taxable estate of the insured. IRC § 2036(a)(2). The use of this strategy in conjunction with an irrevocable life insurance trust is discussed below.

2. **Gift Tax and the Three-Year Rule.** If gift tax is actually paid by a donor, the tax savings that results from the tax-exclusive nature of the gift tax is available only if the senior family member lives for at least three years after making the gift. Congress, recognizing that the gift tax is cheaper than the estate tax, imposes a special rule to prevent death-bed gifts to minimize tax. As a result, if a donor dies during the 3-year period after making the gift, any gift taxes attributable to the gift are added to the donor's gross estate for federal estate tax purposes. IRC § 2035(b). In Dave's example, adding the $3,428,571 in gift taxes paid to Dave's estate would increase his estate tax by $1,371,429, exactly recapturing the benefit that the kids received from the gift.

3. **Carryover Basis.** In making gifts, the issue of basis is always important. While an inherited asset generally gets a new cost basis equal to its value for federal estate tax purposes, property received by gift generally receives a carryover of the donor's basis, increased (but not above fair market value) by the amount of any gift tax paid with respect to the gift. IRC § 1015. In fact, if the beneficiary sells the property for less than the donor's basis, the beneficiary may have his or her basis limited to the fair market value of the property at the date of the gift, if that value is less than the donor's basis. IRC § 1015(a). However, with top capital gains rates at 23.8% and the top estate tax rate at 40%, in most situations, a gift is still more beneficial from an overall tax perspective. This is especially true if the gifted asset is held for a long period of time (thereby deferring the recognition of any income tax payable on the gain), and continues to appreciate in value after the gift is made. One can determine how much an asset must appreciate for any estate tax savings to exceed the income tax costs of a loss of basis step-up by applying an algebraic
formula to compute a "tax efficient appreciation factor." The formula of $1 + \frac{[\text{Unrealized appreciation} \times ((\text{Income tax rate}/(\text{Estate tax rate}-\text{Income tax rate})) / \text{Total gift}]}{\text{Total gift}}$ provides a growth multiple by which the gifted asset needs to appreciate to create estate tax savings sufficient to offset the income tax liability inherent in the appreciation at the time of the gift. For example, a $5 million gift with $1 million of unrealized appreciation would need to appreciate by a factor of 1.29 (to $6.7 million) for the estate tax savings to offset the income tax cost associated with a loss of step-up in basis: $1 + \frac{[$1 million \times ((.238/(.40-.238))/$5 million]}{= 1.29}$.

4. Income Tax Issues. As with intra-family loans and as discussed below, the impact of income taxes on the junior family members needs to be considered. If the senior family members want to assume responsibility for tax on the income earned on the gifted property, the gift can be made to a grantor trust instead of outright to the junior family members. That way, the income tax burden on the assets gifted to the junior family members can remain the responsibility of the senior family member without any additional gift tax. See Rev. Rul. 2004-64, 2004-27 IRB 7. Planning with grantor trusts is discussed in more detail beginning at page 52 below.

5. Giving Discounted Assets. Gifting for wealth transfer usually focuses on giving low valued assets. These values may be the result of market forces, or may result from introduced factors such as gifts of interests in businesses that have lack-of-marketability and minority-interest discounts. If, for example, a fractional interest in real estate or a limited partnership interest in a family limited partnership is being gifted, the leveraging can be magnified. For example, the Tax Court upheld a gift by a mother to her son of a 49% interest in residential property even though the mother continued to live in the property with her son until her death, finding no inclusion in the mother's estate under Section 2036 of the Code. Est. of Stewart v. Comm'r, 617 F3d 148 (2d Cir. 2010). For lack-of-marketability and minority-interest discounts, if the recently released proposed regulations regarding Section 2704 are finalized close to their proposed form, the discounts may be severely impacted. A discussion of these proposed regulations is below.

C. Irrevocable Life Insurance Trusts

Traditionally used as a way of providing liquid assets at the death of an insured for payment of estate taxes, an irrevocable life insurance trust ("ILIT") is not viewed as a component of traditional estate planning in light of higher estate tax exemptions. However, for married couples who want to provide for each other at the death of the first spouse, an ILIT can also be a way to provide a gift to children of prior relationships so that those children don't have to "wait" until the second spouse's death in order to receive an inheritance. In addition, an ILIT can be used as a hedge for any estate tax issues that might arise as a result of other techniques discussed herein. Using an ILIT involves a trade-off between estate exclusion and flexibility of ownership. If the client owns the policy, he or she may change the beneficiary, borrow cash value, pledge the policy as collateral for a loan, and otherwise enjoy the benefits of policy ownership. None of these benefits can be maintained if the policy is acquired by or transferred to an ILIT.

The Technique. An ILIT is an arrangement whereby the grantor establishes a trust to acquire or own insurance on the life of the grantor so that the death benefit of the insurance will not be included in the insured-grantor's taxable estate.

Example 17: Irving and Inez have an estate of $25 million. After considering the impact of projected estate growth, they decide to purchase a $6 million second-to-die policy to pay their estate settlement costs. Cash is transferred to a life insurance trust, and the trustee applies for and purchases the new policy. The trust agreement creates lifetime trusts for their three children. The total premiums paid will be $840,000, in ten installments of $84,000. In each of the ten premium payment years, a gift tax return is filed, electing to use $42,000 of each of the grantors' respective current GST tax exemptions. Irving and Inez also have Wills which contain full trust planning. This example assumes that both spouses die in 2017, and that each spouse's available GST exemption is $5,490,000. After payment of the premiums, their combined estate after estate taxes plus the ILIT is $24,888,000. Without the ILIT or any life insurance, their combined

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estate after estate taxes would be $19,392,000. If they had purchased the $6 million policy and owned it themselves, their combined estate after estates taxes would be $22,488,000.

Specifics.

1. **Structure.** A grantor who desires to acquire life insurance establishes an irrevocable trust with someone else serving as trustee. Instead of purchasing the policy himself, he makes a gift of cash to the trustee. The trustee applies for life insurance on the life of the grantor and uses the cash gift to pay the premium. The trustee of the ILIT is named as the beneficiary of the policy. The grantor may make a large cash gift to the trustee to cover future premiums, but more commonly, each subsequent year, as premiums become due, the grantor makes a cash gift to the trust, and the trustee in turn pays the premiums. Formalities are followed, of course, so that the gifts qualify as present interest gifts. If the ILIT provides for second-generation planning, for each year that gifts are made, the grantor files a gift tax return allocating GST-tax exemption, even if the gifts are less than the annual gift tax exclusion amount. If a primary purpose of the life insurance is to provide liquidity for estate tax purposes, for a married couple, the trust can be established by both spouses and own second-to-die insurance. If the grantor has an existing policy that he wishes to remove from his estate, he could assign ownership of the policy to the trustee, but see the discussion of the three-year rule below.

2. **Incidents of Ownership.** In order to accomplish the objective of excluding the proceeds from the grantor's estate, the insured must not possess any direct or indirect interest in the insurance policy owned by the trust. If the insured possesses any "incident of ownership" over the policy, whether economic or by retaining control, the policy proceeds are subject to federal estate tax in the insured's estate. IRC § 2042. If the insured is married and the insured's spouse is a trust beneficiary, the non-insured spouse must not make contributions to the trust or the spouse will be treated as a grantor, causing inclusion of proceeds in the spouse's estate. For clients who would otherwise use community property funds to make gifts, those funds should be partitioned so that only separate property funds are used.

3. **The Three-Year Rule.** One of the problems in attempting to remove existing life insurance from the insured's estate is the avoidance of the "three-year rule" set forth in Section 2035 of the Code. Any transfer of a life insurance policy by the insured results in inclusion of the proceeds in the insured's estate, if the transfer was made within three years of the insured's death and the transfer was not a bona fide sale for adequate and full consideration. IRC § 2035(d).

Since only a transfer by the insured is subject to application of the rule, if an existing policy that was initially purchased by the insured-grantor is being used, one solution is to have the intended donee, i.e. the trust, purchase the policy from the insured-grantor rather than transferring an existing policy to the trust, so that there will be no transfer of the policy for less than adequate and full consideration. However, if an existing policy is purchased, one must be mindful of the "transfer for value" rules which in some circumstances cause the death benefit to be income taxable to the purchaser of the policy. IRC § 101(a)(2). The transfer for value rules do not apply if the transfer is to the insured, to a partner of the insured, or to a partnership in which the insured is a partner. IRC § 101(a)(2)(B). If the ILIT that purchases the policy is a grantor trust, the policy should be treated as being acquired by the insured for income tax purposes, thus avoiding this issue. See, e.g., PLR 201332001. In addition, the transfer for value rules may be avoided if the insured and the ILIT are partners, even if the ILIT is not a grantor trust (for example, where the ILIT holds an interest in a limited partnership in which the insured is also a partner).

An important line of cases dealt with the purchase of insurance by an irrevocable life insurance trust, using funds furnished by the decedent—the typical structure of an ILIT. Although no formal transfer of the insurance policy by the insured occurs, years ago, the IRS took the position that the arrangement was in substance the same as a transaction whereby the insured bought the policy and then transferred it to the trust. In several cases, the courts held that under this set of facts, the taxpayer never possessed incidents of

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41 If the policy is community property, only one-half is includable in the deceased spouse's estate. Treas. Reg. § 20.2042-1(a)(3).

ownership so Section 2035 was inapplicable. As a result, the IRS has abandoned its position in this area. A.O.D. 1991-012 (07/15/91). Therefore, if a new policy is initially purchased by the trustee, the three-year rule will not apply.

4. **Grantor Trust.** In order to provide greater flexibility regarding the policy, the ILIT may be structured as a grantor trust. A common method of causing the ILIT to be a grantor trust is to include a so-called "swap power." A swap power would allow the grantor, in a nonfiduciary capacity and without the consent of a fiduciary, to reacquire the trust assets by substituting assets of equivalent value. IRC § 675(4). The IRS has ruled that this power is not considered an incident of ownership by the grantor as long as the trustee has a fiduciary obligation to ensure that the substituted assets are of equivalent value and that the power cannot be exercised in a way that can shift beneficial interests. See Est. of Jordahl v. Comm'r, 65 TC 92 (1975); Rev. Rul. 2011-28, 2011-49 IRB 830. A swap power will not be deemed to shift benefits if: (a) the trustee has the power to reinvest trust assets and has a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of its income does not impact the interests of the beneficiaries (such as when the trust is administered as a unitrust or when distributions are limited to discretionary amounts of principal and income). Id. If the trust is a grantor trust, the grantor may be able to sell an existing policy to the trust while avoiding the three-year rule discussed above. In addition, because the trust is irrevocable, it may be difficult to change provisions in later years as circumstances change. By having the trust be a grantor trust, it would be possible to establish a new grantor trust with the desired terms and funded with cash, and then have the new trust purchase the policy without causing negative estate or income tax consequences to the grantor.

5. **Split-Dollar Arrangements.** When contemplating how to pay the premiums for a policy given to an ILIT, the parties may consider using a "split-dollar" arrangement. "Split-dollar" is not a type of insurance. Rather, it is an arrangement in which two parties jointly pay the policy premiums and split one or more of the policy benefits. The requirements to properly structure split-dollar arrangements involving an ILIT, including the differences between the economic benefit and loan regimes, are quite technical and a discussion of the finer points of these arrangements is beyond the scope of this paper. In summary, Treasury Regulations define a "split-dollar arrangement" as one between an owner and non-owner in which (1) either party pays all or part of the premiums, (2) the premium-paying party may recover all or any part of the premiums, and (3) that recovery will be made from the policy values or proceeds, or will be secured by the insurance contract. Treas. Reg. § 1.61-22(b)(1). Generally, split-dollar arrangements require one party to pay the cost of the pure insurance protection provided by the policy, i.e. the term portion, while the other party pays all premiums in excess of the cost of pure insurance protection. The latter party owns the investment portion of the policy (typically measured by the amount of the premiums the investment owner paid, the cash surrender value of the policy, or some similar measure), while the party paying for pure insurance protection receives the death benefit in excess of that required to repay the owner of the investment portion. The term portion owner in a split dollar arrangement is often an ILIT, while the investment portion owner may be the insured's employer, a spouse, or, if suitable restrictions are imposed upon the right to be repaid, the insured him- or herself. Using a split-dollar arrangement in estate planning allows the amount of the gift made to the term portion owner (typically, the ILIT) to be measured not by the total premium, but rather by the cost of pure term insurance, which may be significantly less than the premium cost, especially if the insured is young. As a result, split-dollar arrangements may be advantageous if the insured wants to leverage his or her unified credit or GST tax exemption by minimizing the taxable gift to, and maximizing proceeds received by, an exempt trust. In fact, split-dollar funding of life insurance can be one of the best ways to get the maximum amount of property into an exempt trust, since the gift tax cost per dollar of death benefit is minimized.

If properly structured and as noted above, the investment portion of the split dollar arrangement may initially be substantially less than then amount invested in insurance premiums. This structure may be more pronounced where the insured is quite young and healthy, giving rise to the use of a technique known as "intergenerational discount split dollar." This technique typically involves a senior-generation family

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43 See, e.g., Brody, Richey, & Baier, Insurance-Related Compensation, 386-4th Tax Mgmt. (BNA) U.S. Income, at Art. IV.B.
member (say, a grandparent of the insured), investing in a life insurance policy on the life of a junior family member. Depending on when the senior family member dies, the investment portion held at his or her death may then be significantly less than the premiums paid by him or her. Accordingly, this reduced value, or reduced economic benefit, may lower the value of the investment which will be included in the senior family member’s estate (and thus lower the amount of estate tax due) upon the death of the senior-generational family member.44

D. Sale to an Intentionally Defective Grantor Trust

Rather than making gifts, the senior generation might consider selling assets to an IDGT for the benefit of the junior generation. Although a popular trust strategy, a sale of an asset to an IDGT, can be somewhat complex to explain and expensive to set up. Why bother? For one thing, the payoff is potentially greater than with many other strategies. In addition, a sale to an IDGT can provide a tax-advantaged way to pass assets to children and grandchildren while keeping the value of the trust's assets out of the estates of junior family members, as well as keeping growth of the assets that were sold out of the estates of senior family members. The senior family member may also appreciate the continuing income stream as a result of the interest payments.

The Technique. An IDGT is a trust typically established by senior family members for the benefit of junior family members. Senior family members loan the trust money to buy an asset from the senior generation that has the potential to appreciate significantly. Many people use IDGTs to purchase family businesses or homes. Sales of interests in family limited partnerships or limited liability companies are also popular. Most commentators agree that to be a credit-worthy borrower, the IDGT must have some assets in excess of the borrowed funds with which to repay the note. Also as mentioned in the prior discussion regarding grantor trusts, "seed money" in the minimum amount of 10% of the purchase price is typically recommended. In times of low interest rates, some estate planners consider IDGTs to be the ultimate freeze technique. They combine the interest rate benefits of intra-family loans with the discounting benefits of lifetime gifts. As with outright gifts, this technique works especially well if the sale can be consummated when market values are depressed.

Example 18: Clint has established a family limited partnership that holds $12.5 million in cash and securities.45 Clint has recently had his interest appraised at $10 million (a 20% discount). In July, 2017, Clint establishes an IDGT for the benefit of his children. To buy the limited partnership interest from Clint, the IDGT will need some cash, so Clint gives the trust $1 million. Because Clint wants this trust to endure for generations, he will use some of his $5.49 million GST tax exemption to shelter the trust from the GST tax. With $1 million in cash, plus a $9 million loan from Clint, the trust will buy Clint's limited partnership interest valued at $10 million. The 20-year note from the IDGT to Clint bears interest at the Applicable Federal Rate, which for loans of more than 9 years, was 2.60% in July, 2017.

44 See, Jansen & Ratner, Discount Private Split-Dollar Does It Work?, TR. & ESTS., May 2008, at 19. In a recent case of first impression, the full Tax Court held that the technical requirements set out in the Treasury regulations for satisfying the economic benefit regime were met, suggesting that the estate could use the discounted value of the retained investment portion for federal estate tax purposes. Est. of Morrissette v. Comm'r, 146 TC No. 11 (April 13, 2016). However, the court did not opine on the value itself in this summary judgment proceeding. The taxpayers have filed a motion seeking a partial summary judgment that Code Section 2703(a) does not apply to the arrangement, and the IRS's response was filed on May 22, 2017. Questions remain regarding the tax treatment of intergenerational split dollar arrangements; they have not been widely used, and the IRS may continue to seek other ways to challenge the overall discounts produced. Nevertheless, this initial decision is a significant development regarding intergenerational split dollar arrangements. The Tax Court cited the holding in Morrissette to dispose of the IRS's criticism of a similar arrangement in Estate of Levine v. Commissioner, Tax Ct. Docket No. 9345-15 (order issued July 13, 2016).

45 A discussion of the "proper" way to structure and advise clients as to the administration and management of a family limited partnership or limited liability company is beyond the scope of this paper, but for a recent example of a good way to do it, see Estate of Purdue v. Commissioner, TC Memo 2015-249, and for recent examples of poor ways to do it, see Estate of Beyer v. Commissioner, TC Memo 2016-183 and Estate of Holliday v. Commissioner, TC Memo 2016-51.
Of course, the goal is for the trust's assets to earn enough to cover the loan, while leaving something more for Clint's children and grandchildren. Based on past performance, Clint expects the partnership's investments to appreciate at least 8% a year—that would be more than enough to make the 2.60% interest payments. Over the next 20 years at 8%, Clint can expect that the $12,500,000 in assets owned by the partnership will grow to over $47.5 million, even after paying out $234,000 per year to cover the interest on the note, assuming an interest-only note with a balloon payment at the end of the term. At the end of the 20-year term, the trust will repay Clint his $9 million. After repaying the note, the trust will hold over $38.5 million, which will be available to Clint's children and grandchildren without having paid any gift or estate tax.

Because IDGTs are grantor trusts, Clint won't owe any income tax on the gain he realizes by selling his limited partnership interest to the trust, nor will he have to pay income tax on the interest payments he receives. See Rev. Rul. 85-13, 1985-1 CB 184. As far as the IRS is concerned, it's as if Clint sold the asset to himself. Clint will, however, owe income tax on the partnership's earnings. In this example, though, the interest paid to Clint will more than offset his tax liability so long as the effective tax rate (earned through a combination of dividends, capital gains, and other income) is less than 33.5% or so.

Specifics.

1. **Structure of the IDGT.** The key to the success of an IDGT transaction is the creation by senior family members of an irrevocable trust that (i) successfully avoids estate tax inclusion under Sections 2036 through 2038 of the Code; but (ii) which will be treated as a grantor trust for income tax purposes under Sections 671 through 677 of the Code. The so-called "string statutes" (statutes that cause trusts to be ignored if the grantor retains too many "strings") are similar in the income and transfer tax areas, but they are not the same. There are a number of "strings" on the list for grantor trusts for income tax purposes that have no counterpart when it comes to estate and gift taxes. As a result, clients can create an IDGT, which is ignored for income tax purposes but which will be given full effect for gift and estate tax reasons. When the senior family members sell limited partnership interests or other appreciating assets to the IDGT (sometimes for an interest-only promissory note with a balloon payment although this is more aggressive planning), the sale is ignored for federal income tax purposes. See Rev. Rul. 85-13, 1985-1 CB 184.

2. **Seeding of Trust.** The IRS has offered no official guidance, but most practitioners recommend that the trust have "equity" of at least 10% of the purchase price.46 In most cases, clients provide this "seed" money by making a taxable gift of cash or assets to the trust, typically sheltering the gift from tax by using some of their applicable exclusion amount. A gift tax return is filed, reporting both the seed gift and the sale, thereby starting the gift tax statute of limitations running on the values used in the sale. Some clients can use an existing grantor trust which already has sufficient assets to provide the seed money. Keep in mind that the ideal IDGT is a trust that has been established and funded for some time prior to the sale transaction; otherwise, the IRS might argue that the funding of the trust and sale are a single transaction which would decrease any discounts that might otherwise be available for the transfers. See Pierre v. Comm'r, TC Memo 2010-106. Sometimes it may be impractical for a trust to be seeded with the appropriate level of assets (i.e., the senior family member is unwilling to incur a sizable taxable gift). Instead of (or in addition to partially) seeding the IDGT, the beneficiaries could personally guarantee the promissory note. However, the beneficiaries should independently have sufficient net worth to cover the amount of the guarantee. There is an element of risk with the guarantee approach because the IRS might take the position that the guarantee constitutes a gift from the beneficiary to the grantor trust, or might argue that it raises questions as to the overall financial viability of the transaction. One way to reduce the risk of the gift argument is to have the trust pay the guarantor(s) a reasonable fee for the guarantee.47 Keep in mind that no "correct" way to determine the amount of this fee has been established.

46 Although not condoning this percentage, both the Tax Court and the 9th Circuit recognized this belief in footnotes in Estate of Petter v. Commissioner, TC Memo 2009-280, aff'd 653 F3d 1012 (9th Cir. 2011).
3. **Impact of Interest Rates.** When interest rates are low, sales to IDGTs become very attractive, since any income or growth in the asset "sold" is more likely to outperform the relatively low hurdle rate set by the IRS for the note.

4. **Servicing the Debt.** The nature of this transaction is that there is a sale of assets for a note. Accordingly, all of the typical transaction documents are required, and it seems that it should go without saying that the transaction should be respected. See the discussion above regarding intra-family loans for more information in this regard. It is recommended that the timing and amount of the note payments should not directly tie with the income earned by the assets that are sold. Payments should be made on time and appropriate measures taken if they are not. Otherwise, an argument may be raised that there was no reasonable expectation of repayment and that a gift has been made rather than a bona fide loan. The IRS and Treasury's Priority Guidance Plan for 2016-2017 (released October 31, 2016) includes guidance on valuation of promissory notes under Sections 2031, 2033, 2512, and 7872 as an item on its project list.

With regard to servicing the interest payments on the promissory note, the sale to the IDGT works especially well when rental real estate or other high cash-flow investments are sold. If these assets are contributed to a family limited partnership (or similar entity) prior to being sold to the IDGT, distributions of partnership rental or investment income to the IDGT can be used to service the note payments. As noted above, care should be taken to ensure that payments do not match income; otherwise, the IRS may use this fact in support of application of the step transaction doctrine. See Pierre v. Comm'r, TC Memo 2010-106 (IRS alleged that regular distributions made from a limited partnership in order to service debt incurred in order to purchase interests was a transfer with a retained right to income, causing partnership to be included in transferor's estate under IRC § 2036).

5. **Grantor Trust Implications.** Senior family members must thoroughly understand the notion of a grantor trust. They should understand their obligation to pay tax on the IDGT's income, even if the IDGT does not have cash flow to make interest payments (or if the interest payments are insufficient to service the debt or pay these taxes). The tax payments are not considered a gift by the senior family member. Rev. Rul. 2004-64, 2004-2 CB 7. In addition, since the transaction is ignored for income tax purposes, no basis adjustment is made at the time of the sale. See discussion in the next paragraph regarding termination of grantor trust status while the grantor is living.

6. **Death of Note Holder.** As with an intra-family loan, if the lender dies during the term of the loan, any unpaid balance with accrued interest will generally be included in the taxable estate of the lender. Treas. Reg. § 20.2031-4. Again, however, the value of the note is generally limited to the value of the collateral and the net worth of the borrower, without regard to any amount the borrower might inherit. See Est. of Elizabeth V. Harper, 11 TC 717 (1948), acq., 1949-1 CB 2; TAM 9240003. If the grantor dies before the note is paid in full, or if grantor trust treatment is otherwise terminated before the note is paid off, there may be adverse income tax consequences, including recognition of gain on the sale, and future recognition of interest income on the note payments. See Madorin v. Comm'r, 84 TC 667 (1985); Treas. Reg. § 1.1001-2(c), Ex. 5; Rev. Rul. 77-402, 1977-2 CB 222; cf. Est. of Franek v. Comm'r, 99 F2d 567 (8th Cir. 1993) (gain on SCIN recognized by estate of payee upon death of note holder); Peebles, Death of an IDIT Noteholder, 144 Tr. & Est. 28 (2005). The adverse tax consequences arising from the death of the note holder may be difficult to quantify with any degree of certainty. Nevertheless, if the client is healthy and chooses to do so, the risks can be mitigated by the use of life insurance (perhaps held by an ILIT, as discussed above). If the client chooses to maintain the insurance solely for this purpose, perhaps term insurance maintained only during the term of the note may be used. Note that the IRS and Treasury's Priority Guidance Plan for 2016-2017 (released October 31, 2016) includes guidance on the basis of assets in a grantor trust at the death of the grantor, and as mentioned above, the valuation of promissory notes for transfer tax purposes, as items on its project list.

7. **Benefit to Heirs.** The property in the IDGT net of the note obligation passes to the ultimate beneficiaries (typically junior family members, either outright or in further trust) with no gift tax liability. This is the goal of a sale to an IDGT. If the contributed assets grow faster than the interest rate on the IDGT's note, the excess growth passes to the IDGT beneficiaries with no additional gift or estate tax. With a sale to an IDGT, the IRS requires that the gift tax consequences be evaluated when the assets are sold in
exchange for the note—not when the note is paid off—hence, the term "freeze technique" since the value is frozen for gift tax purposes.

8. **GST Tax Issues.** Unlike a GRAT (discussed below), the senior family member can allocate GST tax exemption to the seed money contributed to the IDGT. As a result of that allocation, the IDGT could have a GST tax inclusion ratio of zero, which means that all of the assets in the IDGT (both the seed money and the growth) can pass on to grandchildren or more remote generations with no additional estate or gift tax, and without any GST tax. This multi-generational feature can make a sale to an IDGT a much more powerful transfer tax tool than other similar wealth-shifting techniques.

9. **Selling Discounted Assets.** It is important that the sale is for the fair market value of the assets. An appraisal of the property may be needed or prudent. Valuation of the interest being sold is extremely important. If the interest transferred is undervalued, the IRS could argue that the interest sold was actually retained by the senior family member, thereby treating the transaction as a gift of the interest pursuant to Code Section 2702. Appreciating or leveraged assets are an ideal candidate for sale. When hard-to-value assets are involved, however, there is a concern that the IRS might argue that the value of the assets sold exceeds the consideration received in the sale, resulting in a taxable gift by the grantor. To protect against a mismatch in value, practitioners often include language in the sales agreement which requires either an adjustment to the purchase price ("price adjustment" clause) or a reallocation of designated property transferred, perhaps with any amount found to be in excess of the amount reported for transfer tax purposes going to charity, a spouse, a zeroed-out GRAT or other non-taxable donee (a "defined value" clause). Although the IRS has challenged the effect of these sorts of clauses, if properly drafted, they have been upheld by various courts. See, e.g., *Wandry v. Comm'r*, TC Memo 2012-88, nonacq. IRB 2012-46 (Tax Court memo opinion approving defined value clause); *Est. of Petter v. Comm'r*, TC Memo 2009-280, aff'd 653 F3d 1012 (9th Cir. 2011) (9th Circuit approval of defined value clause that adjusted amount transferred between taxable and non-taxable recipients); *King v. Comm'r*, 545 F2d 700 (10th Cir. 1976) (approval of price adjustment clause). Cf. *McLendon v. Comm'r*, TC Memo 1993-459, rev’d on other grounds 135 F.3d 1017 (5th Cir. 1997); *Harwood v. Comm'r*, 82 TC 239 (1984) (price adjustment clauses not recognized).48

As noted in the example above, use of lack-of-marketability and minority-interest discounts can provide more bang for the buck. The trust pays interest at favorable rates on the discounted value, while the underlying assets grow at full market rates. Section 2704 of the Code may also affect the discounts that apply when assets are transferred between certain family members. It was rumored for years that Treasury planned to exercise its authority to issue regulations under Section 2704 that would limit (or possibly eliminate?) these discounts, and proposed regulations were released on August 4, 2016. A discussion of these proposed regulations is below.

10. **Lack of Certainty and Planning Cautions.** There are plenty of caveats. Neither the Code nor case law specifically addresses IDGT’s, and the IRS is known to challenge them. In fact, in two companion cases filed in Tax Court in December, 2013, the IRS alleged that the note received by the taxpayers when assets were sold by them to an IDGT was not a note at all, and, applying the special valuation rules of Chapter 14 of the Code, valued the amounts received by the taxpayers at $0, meaning that the entire value of the property transferred was treated as a gift. Then, applying different rules, the IRS asserted that the transferred assets are includable in the taxpayer-husband's estate for federal estate tax purposes. See *Est. of Donald Woelbing v. Comm'r* (Tax Ct. Docket No. 30261-13); *Est. of Marion Woelbing v. Comm'r* (Tax Ct. Docket No. 30260-13).49 In addition to IRS challenges, the Obama administration's

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48 The IRS's continued animosity toward these clauses is demonstrated in two companion cases currently pending in Tax Court in which the IRS has asserted a combined gift tax deficiency of over $33 million. The cases involve a split gift with a defined value clause that required the donee to purchase any units transferred in excess of a set value as finally determined for federal gift tax purposes. *Karen S. True v. Comm'r*, Tax Ct. Docket No. 21896-16; *H. A. True v. Comm'r*, Tax Ct. Docket No. 21897-16.

49 These cases were settled on March 25 and March 28, 2016, respectively, so we will not have any definitive court decision in these matters. The note involved bore interest at the AFR, and the sale was partially seeded with guarantees by Mr. Woelbing's sons, who were beneficiaries of the trust, so a Tax Court decision on the merits would have been interesting to see. The orders on the stipulated decisions close the estate and gift tax issues in the Estate of Donald
budget proposals for the past four fiscal years included a recommendation that legislation be enacted to eliminate the tax benefits of sales to IDGTs. The current administration issued its budget "blueprint" on March 16, 2017, but it contains no specific discussion of proposed tax law changes. As of the date of this article, a detailed budget proposal from the current administration has not been published.

Aside from the tax risk, there is also the financial risk that the trust may simply go bust. Like in the example above, if the assets in the IDGT decline in value, the trust will have to come up with the cash to pay Clint. If Clint took back a security interest in the property that was sold, he could seek foreclosure on the property. Also, the IDGT can always use the money Clint gave it—the $1 million—to repay him. If that happens, Clint won't be able to reclaim the $1 million gift and GST tax exemptions he used when the trust was created. These exemptions will have been wasted.

While sales to IDGTs promise many tax benefits, one must remember that unlike GRATs (discussed below), the IRS has not sanctioned the tax and financial principles employed in this technique. Its litigation posture in cases such as the *Woelbing* cases cited above may indicate that the IRS will attempt to thwart the benefits promised by sales to IDGTs.

**E. Accidentally Perfect Grantor Trusts**

With a much larger federal estate tax exemption, maybe we should consider standing some traditional estate planning tools on their heads. Instead of an intentionally defective grantor trust, why not create an "Accidentally Perfect Grantor Trust" ("APGT")? Although the concept is somewhat different, in the right circumstances, the benefits could be dramatic. The typical candidate is a self-made individual whose parents are people of modest means. Using this technique can actually benefit the donor fairly directly, in a tax-advantaged way.

**The Technique.** An APGT is a trust established by a junior family member, typically for the benefit of his or her children or other descendants. The trust may also provide benefits for the grantor's parents or more senior family members. Junior gives low-basis or highly appreciating assets to the trust. Alternatively, junior structures the trust as an IDGT, contributes appropriate "seed" money, and loans money to the trust for the trust to buy an asset with lots of appreciation potential from junior.\(^{50}\) Regardless of whether the trust is funded primarily by a gift or a sale of assets, this trust has a twist. From day one, the trust has language built into it that causes the trust assets to be *included in the estate of a senior generation family member for federal estate tax purposes*. As a result, upon the death of the senior family member, the trust assets will receive a new cost basis. A similar result could be achieved by having the junior family member simply give property to the senior family member with the hope that the senior family member bequeaths the property back to junior in trust. The APGT, however, may allow junior to (i) protect assets from the creditors of the senior family member; (ii) use less of junior's gift tax exemption (by selling assets to the IDGT for a note); and (iii) allow junior to prescribe the terms of the trust into which the assets pass upon the death of the senior family member. In addition, depending upon the structure, the resulting trust may be a grantor trust as to junior even after the senior generation family member is gone, providing a vehicle for future tax planning.

**Example 19:** Jenny owns the stock in a closely held business that she thinks is about to explode in value. She would like to transfer future appreciation to her children, but does not want to give up all of the value, and doesn't like the fact that the stock will have such a low cost basis. Jenny's mom Mary has a net worth of perhaps $100,000. Jenny recapitalizes the company so that it has 1 voting share and 999 non-voting shares. Jenny then sets up an IDGT for the benefit of her children (and perhaps Mary), and sells the non-voting stock to the trust for its current appraised value of $1 million. She uses a combination of seed money and a guarantee by Mary and the children to make sure that the sale is respected for income and gift tax

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\(^{50}\) In addition to the discussion above regarding the use of intentionally defective grantor trusts, see Hodgman, *IDGTs on Steroids: Current Conditions Strengthen Benefits*, 38 E ST. PLAN. 7, 3 (2011), and Akers, *Transfer Planning, Including Strategies to Maximize Benefits of GRATs and Sales to Grantor Trusts Given Recent Market Declines*, Dallas Estate Planning Council, May 2009.

Woelbing and the gift tax issues in Estate of Marion Woelbing. Any estate tax issues in the Estate of Marion Woelbing's estate have not been addressed.
purposes. The trust has language that grants Mary a general testamentary power to appoint the trust property to anyone she chooses. Mary signs a new will that leaves the trust property to a dynasty trust for Jenny and her descendants, naming Jenny as the trustee. (Just in case, the IDGT contains the same type of dynasty trust to receive the property if Mary fails to exercise her power of appointment). When Mary dies four years later, the stock has appreciated to $2 million in value. Because the trust assets are included in Mary's estate, the stock gets a new cost basis of $2 million. The value of the trust assets, when added to the value of Mary's other assets, is well below Mary's available estate tax exemption. Mary's executor uses some of Mary's GST tax exemption to shelter the trust assets from estate tax when Jenny dies. Despite the fact that Jenny will now have the lifetime use of the new trust's property: (i) it can't be attached by her creditors; (ii) it can pass to Jenny's children, or whomever Jenny wishes to leave it to, without estate tax; (iii) principal from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants without gift tax; and (iv) if the trust isn't a grantor trust as to Jenny, income from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants, thereby providing the ability to shift the trust's income to taxpayers in lower income tax brackets.

Specifics.

1. Structure of the APGT. Although the term "accidentally perfect" distinguishes this trust from an "intentionally defective" trust, there is nothing accidental about it. The key to the success of an APGT is the creation by a junior family member of an irrevocable trust that (i) successfully avoids estate tax inclusion for the junior family member under Sections 2036 through 2038 of the Code; but (ii) which will intentionally cause estate tax inclusion for a senior family member who has estate tax (and GST tax) exemption to spare. The APGT would typically be structured as an IDGT as to the junior family member, and if a sale is involved, it would buy rapidly appreciating assets from the junior family member. It would maintain its grantor trust status as to the junior family member at least until the purchase price is paid. The difference is that the agreement establishing the APGT also grants a senior family member a general power of appointment over the trust, thereby ensuring inclusion of the trust assets in his or her taxable estate (and thereby ensuring a new cost basis at the time of the senior family member's death). The amount of the APGT's property subject to the general power could be limited by a formula to ensure that (i) only appreciated non-IRD assets could be appointed; and (ii) inclusion of those assets in the senior family member's taxable estate doesn't cause estate tax to be payable when that person dies. When the junior family member sells appreciating assets to the trust, the trust's IDGT provisions ensure that the sale is ignored for federal income tax purposes. See Rev. Rul. 85-13, 1985-1 CB 184. Nevertheless, the assets are subject to estate tax (with the attendant income and GST tax benefits) upon the death of the senior family member.

2. Basis Issues. If the senior family member exercises the general power of appointment, the assets of the APGT receive a new cost basis pursuant to Code Section 1014(b)(4). But even if the power of appointment is not exercised, the assets of the APGT are included in determining the value of the estate of the senior family member under Code Section 2041(a)(2). As a result, those assets receive a new cost basis in the hands of the taxpayer to whom they pass. IRC § 1014(b)(9). If the junior family member gives assets to a senior family member, and those same assets are inherited by the donor (or the donor's spouse) within one year, there is no step-up in the basis of the assets. IRC § 1014(e). With an APGT, however, upon the death of the senior family member, the assets do not pass back to the donor/junior family member, but to a different taxpayer—a dynasty trust of which the donor/junior family member is a beneficiary. Although the IRS has privately ruled otherwise, (see, e.g., PLR 200101021), the fact that the recipient of the property is a trust, and not the donor, might permit a new basis, even if the senior family member dies within a year of the assets being given to the APGT. Of course, if the senior family member survives for more than a year, the limitations under Section 1014(e) won't apply. Suppose that the junior family member sold assets to the trust for a note. If the asset is worth $1 million, but is subject to a debt of $900,000, then presumably only $100,000 is includable in the senior family member's estate. Nevertheless, the basis of the asset should be adjusted to its $1 million value, and not just $100,000. See Crane v. Comm'r, 331 US 1 (1947).

There are two areas that may raise issues regarding a full basis adjustment at death, one in the case of a sale of assets to the APGT and one in the case of property being depreciated where the senior member
does not exercise the power of appointment. Despite the clear holding in *Crane*, the first issue is found in Treasury Regulation Section 20.2053-7. The regulation provides that a decedent's estate will include the full value of property for which the estate is liable for any indebtedness on the property, whereas only the net value of the property need be returned if the estate is not liable. Although the regulation appears to address a reporting position only and does not provide that the full value of the property may not be reported, it may be prudent to have the senior family member personally guarantee the payment of the debt to ensure that all of the property and not just the net value will be reportable as part of his or her estate. Regarding the second issue, note that if the power of appointment is not exercised by the senior family member, the basis adjustment arises under Code Section 1014(b)(9) instead of Code Section 1014(b)(4). Unlike the other provisions of Code Section 1014, as mentioned above, Section 1014(b)(9) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent prior to the decedent's death. Because the APGT is a grantor trust, the junior family member is presumably "the taxpayer" for this purpose. The Section 1014(b)(9) limitation would appear to apply to any depreciation deductions taken by the junior family member prior to the death of the senior family member. As a result, if the APGT remains a grantor trust as to the junior family member after the senior family member's death, then the amount of the basis adjustment might be reduced by the amount of the depreciation deductions allowed to the junior family member prior to the senior family member's death. See Treas. Reg. § 1.1014-6.

3. **Impact of Interest Rates.** As with IDGTs, when interest rates are low, sales to APGTs become very attractive, since any income or growth in the asset "sold" is more likely to outperform the relatively low hurdle rate set by the IRS for the note. Remember, in a sale context, it is the growth in excess of the purchase price (plus the AFR on any part of the deferred purchase price) that is kept out of the estate of the junior family member, and instead ultimately lands in a dynasty trust for the junior family member.

4. **Benefit to Heirs.** The property in the APGT passes to a new dynasty trust for the ultimate beneficiaries (typically one or more generations of junior family members). With a sale to an APGT, if the purchased assets grow faster than the interest rate on the note, the excess growth is held in the APGT, ultimately becoming available to the beneficiaries of the APGT. The goal of an APGT is the same regardless: The assets ultimately pass for the benefit of the grantor or his or her descendants in a creditor-proof, estate-tax exempt, and GST-tax exempt trust, and with a new cost basis equal to the fair market value of the trust assets at the time of the senior family member's death, all without estate tax, and possibly without gift tax.

5. **Income Tax Issues.** What is the income tax status of the dynasty trust that is formed after the death of the senior family member? If the junior family member is a beneficiary, and the successor dynasty trust arises as a result of the failure of the senior-generation family member to exercise the power of appointment, one can make a compelling argument that the trust can be characterized as a grantor trust as to the junior family member, since he or she is the only transferor of property to the trust. Treas. Reg. § 1.671-2(e)(5). On the other hand, if the successor trust arises as a result of the senior family member actually exercising the power of appointment, then the senior family member will be treated as the grantor of the successor dynasty trust for federal income tax purposes, even if the junior family member was treated as the owner of the original trust. *Id.* The regulations thus appear to provide a choice, to be made by the selection of language in the senior generation family member's will, to decide whether the successor trust will be a "defective" trust as to the junior family member after the death of the senior family member. If grantor trust treatment is maintained, the resulting trust would have the features of a so-called "beneficiary defective grantor trust" but without the attendant requirement that the trust always remain a grantor trust after the death of the senior family member.  

6. **Estate Tax Issues.** As noted above, estate tax inclusion in the estate of the senior family member (with its resulting basis adjustment) is one of the goals of the APGT. But can the IRS argue that the dynasty trust that arises for the benefit of the junior family member after the death of senior is includable in junior's estate? As noted above, junior may be treated as the grantor of the resulting trust for income tax purposes. For estate tax purposes, however, the existence of the power of appointment in the senior family
member results in a new transferor. So long as the resulting trust limits junior's access to those rights normally associated with a descendant's or dynasty trust (e.g., limiting junior's right to make distributions to him- or herself by an ascertainable standard, and allowing only limited powers of appointment), there should be no inclusion of the trust's assets in junior's estate at the time of his or her later death. See PLR 200210051. See also PLRs 200403094, 200604028. In some states, since the trust was originally created by junior, a court might be empowered to award trust assets to junior's creditors if junior becomes a beneficiary of the trust. In that event, the IRS might assert that Section 2041(a)(2) of the Code (transfer with a retained right to appoint property to one's creditors) applies to subject the resulting trust to estate tax in junior's estate. States with domestic asset protection trust statutes may avoid this concern. In addition, other states may include features in their spendthrift statutes or otherwise to provide protection in this circumstance. See, e.g., TEX. PROP. CODE § 112.035(g)(3)(B) (beneficiary's possession of general power of appointment precludes trust contributions from being treated as being made by grantor for purposes of applying Texas spendthrift protection).

7. GST Tax Issues. The donor can allocate GST tax exemption to any gift to the APGT, but if the entire trust is expected to be included in the taxable estate of the senior family member, the donor would probably not do so. To maximize the benefits, the executor of the estate of the senior family member can allocate GST tax exemption to property subject to the general power of appointment. See IRC § 2652(a)(1)(A); Treas. Reg. § 26.2652-1. As a result of allocation, the dynasty trust that receives the APGT assets will have a GST tax inclusion ratio of zero, which means that all of those assets (both the seed money and the growth) can pass into trust for the APGT grantor, and ultimately on to grandchildren or more remote generations, with no additional estate or gift tax. This multi-generational feature makes a sale to an APGT a very powerful transfer tax tool.

8. Selling Discounted Assets. As discussed above with sales to more traditional IDGTs, rapidly appreciating or leveraged assets are ideal candidates for sale. The use of lack-of-marketability and minority-interest discounts can increase the benefits of the technique. For a discussion of the recently released proposed regulations regarding Section 2704 which may affect these discounts, see below.

F. Grantor Retained Annuity Trusts

With a grantor retained annuity trust, or "GRAT," heirs typically won't receive quite as much as they would with an IDGT. But GRATs are also less risky, in part because they can be set up to completely avoid any gift tax consequences. Moreover, because the Code sanctions them, as long as the guidelines are followed, there is very little risk of running afoul of the IRS. In fact, GRATs have been so successful that President Obama's last budget proposal, following similar requests in 2010-2013, asked Congress to impose some restrictions on the use of GRATs, for example, requiring them to have a term of at least ten years, a remainder interest equal to greater than zero, and prohibit any decrease in the annuity during the GRAT term.52

The Technique. In many ways, GRATs resemble loans. The grantor sets up a trust and transfers property to the trust. The trust itself requires the trustee to make payments to the grantor in the form of an annuity. As with a loan, a GRAT matures within a specified number of years. As a result, any money (or assets) that the client puts into the GRAT will be returned through the annuity payments by the time the trust terminates. So, what's in it for the client's beneficiaries? Assuming all goes well, a big chunk of the earnings will go to them, free of gift and estate taxes.

Because a successful GRAT is one that appreciates a lot, it's best to select an asset that the client thinks is on the verge of rapid appreciation. The classic example: shares in a privately held company that is likely to go public, or oil and gas interests in which future production is eminent. These days, beaten-down real

52 See U.S. Treasury, General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals (Feb. 2016), (commonly called the "Greenbook"), available at https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf. The current administration issued its budget "blueprint" on March 16, 2017, but it contains no specific discussion of proposed tax law changes. As of the date of this article, a detailed budget proposal from the current administration has not been published.
estate is also a good candidate if it produces positive cash flow. In reality, any asset that the client expects to rise in value more rapidly than the IRS interest rate will work, but the higher the appreciation, the better.

**Example 20:** Greta owns all of the stock in her closely held business. Although there is no deal on the table, some potential buyers have expressed an interest in buying the company for $15 million. Nevertheless, a business appraiser values a one-third interest in the company at $3 million (applying traditional lack-of-marketability and minority-interest discounts). Greta decides to transfer one-third of her stock to a GRAT, retaining the right to get back the $3 million of value she put into the trust in equal annual installments. Greta will also receive a little extra—an annual interest payment designed to make sure she takes back what the IRS assumes the stock will be worth in 10 years when the trust expires. To estimate the rate at which investments in a GRAT will grow, the IRS uses the so-called "7520 rate," which is based upon 120% of the monthly mid-term Applicable Federal Rate. When Greta set up her GRAT in July, 2017, the 7520 rate was 2.2%.

If Greta's stock appreciates by more than the 2.2% annual hurdle rate, the excess profits will remain in the trust and eventually go to her two children. In fact, if the sale eventually goes through, the trust will hold $5 million (remember that Greta only gave away one-third of her stock). If that happens, nearly $2 million in value will pass to the kids with no gift or estate tax. If the sale doesn't happen and the stock doesn't increase in value, the trust will simply give Greta her stock back over the term of the trust. In that event, Greta may have "wasted" some money on professional fees (the attorney, accountant and appraiser fees she spent to set up the trust, value the stock, and report the gift), but the GRAT will simply pay her back what's left of her investment by the time it expires—no one is required to make up for a shortfall.

**Specifics.**

1. **Structure.** In the typical GRAT, a senior family member transfers assets to a trust, which provides that he or she will receive an annual annuity payment for a fixed number of years. The annuity amount can be a fixed dollar amount, but most estate planners draft the GRAT to provide for the payment of a stated percentage of the initial fair market value of the trust. That way, if the IRS challenges the initial valuation, the payment automatically adjusts. As discussed below, most GRATs are "zeroed out"—that is, payments are usually set so that the actuarial value of the interest passing to the heirs is very close to zero. Once property is contributed to the GRAT (i) no additional assets can be contributed; and (ii) the GRAT cannot be "commuted" or shortened by accelerating payments.\(^{53}\)

2. **Setting the Annuity.** The annuity can be a level amount, or an amount that increases each year, although the Treasury regulations limit the amount of each annual increase to not more than 20% per year. Treas. Reg. § 25.2702-3(b)(1)(ii). By providing for an increasing annuity payment each year, payments can be minimized in early years leaving more principal to grow in the GRAT for a longer period of time. If the asset consistently grows in value at a rate that exceeds the GRAT interest rate, retaining these extra funds will allow the principal to grow even more.

3. **Gift on Formation.** Upon the creation of the GRAT, the grantor is treated as making a gift to the ultimate beneficiaries equal to the initial value of the trust assets, reduced by the present value of the annuity payments retained by the senior family member. IRC § 2702; Treas. Reg. §§ 25.2702-1, -2. Since a GRAT results in a gift of a future interest, no annual exclusion can be used to shelter the gift tax. IRC § 2503(b)(1). As a result, taxpayers who set up GRATs must file gift tax returns to report the transfer. The present value computation of the retained annuity is based upon the term of the GRAT and the Section 7520 rate in the month that the GRAT is created. IRC §§ 2702(a)(2)(B); 7520. Fortunately, the IRS is bound by the actuarial computation performed in the month the GRAT is created. The IRS can't come back at the end of the GRAT term and re-assess how the GRAT actually did to measure the gift tax. The trustee of the GRAT must be sure to make the annuity payments to the grantor on time, pursuant to the terms of the GRAT. Otherwise, the IRS could recharacterize the gift as a gift of the full value of the gifted asset on formation, with no reduction for the value of the promised annuity payments.

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\(^{53}\) For the safe harbor treatment, see Treas. Reg. § 25.2702-3(b).
4. Impact of Interest Rates. The common wisdom is that GRATs work best in times of low interest rates and depressed markets. This notion is based upon the fact that the lower the Section 7520 rate, the lower the annuity payments need to be to zero out the GRAT so that the value of the gift is zero or close thereto. As a result, at the end of the annuity term, more assets will be available to pass to the ultimate beneficiaries gift-tax free. Surprisingly, studies have shown that for short-term GRATs, current interest rates have very little impact on the success rate of the GRAT. Instead, GRATs work best when the value of the assets contributed to the GRAT are depressed and rebound in the short term to far exceed their value at the time of contribution. In fact, one study showed that the success of short-term GRATs are impacted only about 1% by the Section 7520 rate, 66% by first-year growth, and 33% by second-year growth. 54

5. Zeroed-Out GRATs. The most popular form of GRAT involves a short-term, "zeroed out" GRAT, in which the term of the GRAT is limited to no less than two years, and the present value of the retained annuity amount is structured to nearly equal the amount transferred to the GRAT. This approach produces a very small (near zero) taxable gift. The shorter term may increase the likelihood that the senior member will survive the annuity term, so that none of the GRAT assets will be includible in his or her gross estate for estate tax purposes.

6. Multiple GRATs. Clients with diversified investment portfolios might want to use a separate trust for each class of investments they own. For example, a client might set up three $1 million GRATs—one composed of U.S. small-cap stocks, another of commodities, and a third of emerging-markets stocks. If any of these three asset classes outperform the 7520 rate, the client will have effectively shifted wealth. Those assets that underperform will simply be returned to the client, perhaps to be "re-GRATed". Had the client instead combined these three volatile investments into a single GRAT, he or she would run a risk that losses on one might offset gains on another. Many advisers favor limiting GRAT terms to as few as two years. That way, if a particular investment soars, the client will be able to lock the gains in for the remainder beneficiaries before the market cycles back down again.

7. Grantor Trust Implications. As with IDGTs, GRATS are grantor trusts. As such, they allow the grantor to pay capital gains and income taxes on the investments in the GRAT on behalf of his or her heirs. Because the IRS doesn't consider such tax payments a gift, they are another way to transfer wealth to the next generation free of gift and estate taxes. Rev. Rul. 2004-64, 2004-2 CB 7.

8. Death During GRAT Term. If the senior family member dies during the annuity period, the senior family member's estate will include the lesser of (i) the GRAT assets at the date of death; or (ii) the amount necessary to yield the remaining annuity. See Treas. Reg. §§ 20.2036-1(c), 20.2039-1(e); T.D. 9414 (7/14/08). Unless interest rates rise dramatically, or the trust's assets appreciate in value very rapidly, the amount necessary to yield the remaining annuity will probably be very close to the entire value of the GRAT. If that is the case, virtually the entire GRAT value gets included in the estate of the deceased senior family member. Since the amount includable is the lesser of the date-of-death value of the trust or the amount need to continue the annuity, it is important to make the latter calculation. Future fluctuations in interest rates and when death occurs both impact upon the amount of the estate tax that may arise if the grantor dies during the GRAT term, making the estate tax exposure somewhat difficult to quantify with precision. Nevertheless, if the senior family member is healthy, he or she can consider the use of life insurance (typically held by an ILIT, as discussed above) to mitigate the risk of estate tax exposure arising from a death during the GRAT term. He or she can consider using term insurance maintained only during the term of the GRAT if the insurance is to be used solely for mitigation purposes.

9. Payments in Kind. The annuity does not have to be paid in cash. Instead, it can be paid "in kind" (i.e., with a portion of the assets initially contributed to the GRAT). However, if the GRAT assets are rapidly appreciating, a return of these assets creates a "leak" in the freeze potential of the GRAT. One partial solution to this "leak" is to have the grantor contribute the distributed assets into a new GRAT. A GRAT must expressly prohibit the use of a promissory note to make the GRAT payments. Treas. Reg. § 25.2702-3(b)(1)(i). Regardless of whether the annuity payment is made in cash or in kind, the payment must be made within 105 days of the anniversary date of the GRAT if payment is based on the date of the

trust, or by the due date of the trust's income tax return (without regard to extensions) if the payment is based on the trust's tax year. Treas. Reg. § 25.2702-3(b)(4).

10. **Benefit to Heirs.** At the end of the annuity period, the property remaining in the GRAT (after paying the senior family member the annuity pursuant to the GRAT terms) passes to the ultimate beneficiaries (typically junior family members, either outright or in further trust) with no further gift tax liability. This is the goal of a GRAT, and why highly appreciating assets work best. If the contributed assets grow faster than the GRAT interest rate, the excess growth passes to the GRAT beneficiaries. Remember, the IRS requires that the gift tax consequences be evaluated when the GRAT is created—not when the GRAT term comes to an end. As a simplified example, if the senior family member has an interest in a family limited partnership, the senior family member might consider transferring a portion of the limited partnership interests to a single member limited liability company owned by the senior family member and having the limited liability company purchase the remaining limited partnership interests for a note. The senior family member then contributes the limited liability company interest to a GRAT. The value of the limited liability company interest should be the value of the contributed limited partnership interests. Structured carefully, the cash flow from the entire limited partnership interest would be available to service the relatively small annuity payments required by the GRAT.55

11. **GST Tax Issues.** Unfortunately, in contrast to a sale to an IDGT, the senior family member cannot allocate GST tax exemption to the GRAT until the end of the GRAT term (i.e., the end of the estate tax inclusion period or "ETIP"). See IRC § 2642(f). Therefore, the senior family member cannot leverage the GST tax exemption by allocating it to the GRAT property before it appreciates in value. To circumvent the ETIP rules, some practitioners have suggested that the remainder beneficiaries of the GRAT could sell their remainder interest to a GST exempt dynasty trust, from which distributions can be made to future generations free of transfer taxes; however, there are no cases or rulings approving this sort of transaction. The ETIP rules mean that GRATs do not allow for efficient allocation of GST tax exemption. Therefore, GRATs are typically drafted to avoid the imposition of GST tax. For example, children can be given a "conditional" or standard general power of appointment (although doing so may hamper creditor protections of a dynasty trust). Naturally, if the GRAT assets remain in trust and are expected to continue to appreciate after the GRAT term ends, it may be worthwhile to allocate GST tax exemption to the trust at the end of the GRAT term based upon the fair market value of the assets retained by the trust at that time. See the discussion below regarding HEETs as an option for dealing with the GST tax issues of a GRAT.

12. **Short-term vs. Long-term GRATs.** As indicated above, the use of short-term (i.e., 2-year) GRATs have typically been more popular than using longer-term GRATs. The reasoning behind the preference for short-term GRATs is twofold. First, using a short-term GRAT reduces exposure to the risk that the senior family member will die during the term, which, as stated above, would cause all or a portion of the value of the GRAT assets to be included in the senior family member's gross estate. Second, a short-term GRAT minimizes the possibility that a year or two of poor performance of the GRAT assets will adversely impact the overall effectiveness of the GRAT. When funding a GRAT with volatile securities, a series of short-term GRATs typically perform better than a single long-term GRAT. Notwithstanding the benefits of short-term GRATs illustrated above, in times of low interest rates, a longer-term GRAT may be more desirable because it allows the senior family member to lock in a low 7520 rate for the duration of the GRAT term.56 In addition, with a longer-term GRAT, the client saves the expenses each time a new GRAT is made for a shorter term, and the client does not have to go through the process of forming and funding a new GRAT.

13. **Insuring the GRAT.** As mentioned above, if the senior family member dies during the annuity term, all or a portion of the GRAT assets will be included in his or her gross estate. In that event, the GRAT would be ineffective to pass assets to the senior family member's beneficiaries free from estate or gift tax. In order to "insure" that the GRAT technique works, a life insurance policy can be purchased on the senior family member's life which coincides with the term of the GRAT and the assets contributed to it (e.g., for a 10-year GRAT, the client would buy a 10-year term policy with a face value equal to the

56 See Melcher, Are Short-Term GRATs Really Better Than Long-Term GRATs?, 36 EST. PLAN. 3 (2009).
projected estate tax that would otherwise be imposed if the GRAT fails). Such a policy would presumably be purchased by an irrevocable life insurance trust ("ILIT") so that the proceeds of the policy would not be subject to estate tax upon the senior family member's death.

**14. Other Limitations of GRATs.** As with any estate planning technique, there are drawbacks. Because GRATs have to pay higher interest rates than short-term and medium-term family loans, they pass along slightly less to heirs than a comparable IDGT. In addition, GRATs must make fixed annual payments. Unlike a sale to an IDGT, the grantor can't defer the bulk of the payments for years into the future by using a balloon note. The biggest risk with a GRAT is that the client might die before the trust ends. In that situation, all or part of the GRAT assets will be included in the client's estate and potentially subject to estate tax.

**G. Qualified Personal Residence Trusts**

In most cases, a gift to a trust in which the grantor retains the benefit of the trust property requires that for gift tax purposes, the value of the grantor's retained interest be ignored. In other words, the full fair market value of the property transferred is treated as a gift, even though an interest in that property is retained by the grantor. IRC § 2702. The Code provides an exception to this rule, however, if the property contributed is a personal residence. IRC § 2702(a)(3)(A)(ii). Personal residences, either in the form of primary residences or vacation homes, often comprise a substantial amount of clients' wealth. Parting with these assets can provide estate tax savings, particularly when substantial appreciation is expected, and the family intends to retain the home for many years. The value of the gift to the trust is the fair market value of the residence less the value of the retained right to occupy the residence. By parting with the residence now, but making the transfer effective in the future, a client may transfer the asset (and its subsequent appreciation) at a discount.

**The Technique.** As the name of this type of trust implies, a qualified personal residence trust ("QPRT") is a trust into which the grantor transfers a personal residence. The trust is used to transfer the residence to other beneficiaries, such as trusts for junior family members, at a reduced gift tax cost, while allowing the grantor to continue to live in or use the residence. The grantor retains the full use of the residence during the term of the trust, which is typically a fixed number of years. At the end of the trust term, the residence passes to the trust beneficiaries.

**Example 21:** Homer, age 60, transfers a vacation home worth $3,000,000 to a QPRT, retaining the right to occupy the house for fifteen years. The remainder interest in the trust is held for the benefit of Homer's children. Language is added to the trust document to cause the house to revert to Homer if he dies during the fifteen-year term. The actuarial factor for the interest retained by Homer (assuming a current interest rate under Section 7520 of 2.2%) is 0.46823. The actuarial factor for the remainder interest is 0.53177. As a result, the value of the gift is $1,595,310 (0.53177 × $3,000,000). If the house appreciates at six percent per year, and if Homer survives the term of the trust, the house, then valued at nearly $7.2 million, will have been transferred to Homer's children at a gift tax cost of approximately $1.6 million. If Homer dies during the fifteen-year term, the house will be included in Homer's estate at its then fair market value, but no tax detriment will have been suffered. The estate tax effect in that event would be as if Homer had undertaken no planning (except for the transaction costs). IRC § 2036.

**Specifics.**

**1. Structure.** The terms required to establish a QPRT are set forth by Treasury regulations and the IRS has issued a sample trust agreement for establishing the trust. Treas. Reg. § 25.2702-5(c); Rev. Proc. 2003-42, 2003-1 CB 993. The grantor creates an irrevocable trust. During the initial term of the trust, the grantor continues to use the residence rent-free and continues to pay mortgage expenses, real estate taxes, insurance, and expenses for upkeep. PLRs 199916030, 19924904. At the same time, the grantor continues to deduct mortgage expenses and real estate taxes for income tax purposes. At the end of the term, the residence passes either outright or in further trust for junior family members. Like with a GRAT, the interest in a QPRT may not be commuted. Treas. Reg. § 25.2702-5(c)(6). The residence can include appurtenant structures used for residential purposes and additional property not in excess of that reasonably appropriate for residential use. Treas. Reg. § 25.2702-5(c)(2)(ii). To qualify as a personal residence, its
primary use must be that of a residence of the grantor when occupied by him or her. Treas. Reg. § 25.2702-5(e)(2)(iii). In general, a "personal residence" includes the grantor's principal residence or a vacation property. At the end of the trust term, if the grantor desires to continue to use the residence, the grantor may rent it from the junior family members (or the trusts for their benefit), thereby transferring additional assets out of senior's taxable estate in the form of rental payments.

2. **Residence, Cash and Proceeds.** The trust must provide for retained use of a personal residence by the grantor and may provide for occupancy by the grantor's spouse, if married, or a dependent of the grantor. Treas. Reg. § 25.2702-5(c)(7)(i). If the residence ceases to be used as a residence for any reason, including sale of the property, it will no longer be a QPRT. However, a QPRT may permit the trustee to sell the residence (other than to the grantor, the grantor's spouse, or an entity controlled by one of them) and invest the sales proceeds into a new residence in order to continue to qualify. Sales proceeds that are not either distributed to the grantor or reinvested in a new residence within two years, must be held in a GRAT for the grantor's benefit for the remainder of the QPRT term. Treas. Reg. §§ 25.2702-5(c)(5)(i)(C), -5(c)(7)(ii), -5(c)(8), -5(c)(9). A QPRT is permitted to hold cash, provided that the total cash held in the trust does not exceed the amount required to pay trust expenses (including mortgage payments and improvements to the residence) that are anticipated to arise within six months from the date the cash is contributed. Treas. Reg. §§ 25.2702-5(c)(5)(ii)(A)(1)(i), (ii). In addition, the QPRT may hold cash for the purchase of an initial residence within three months of the date that the trust is created as long as the trustee has already entered into a contract to purchase the residence, or it may hold cash to purchase a replacement residence within three months of the date that the addition is made, provided that the trustee has entered into a contract to purchase that residence. Treas. Reg. §§ 25.2702-5(c)(5)(ii)(A)(1)(iii), (iv).

3. **Gift Tax Considerations.** The gift portion of a QPRT is the actuarial value of the remainder interest determined under Section 7520, using the applicable federal rate for the month in which the residence is transferred to the trust. Treas. Reg. § 1.7520-1. If the home reverts to the grantor upon the grantor's death during the term of the trust, the value of the interest retained by the grantor must be increased by the value of the reversionary interest. IRC § 2702(a)(3); Treas. Reg. § 25.2512-5(d)(2); PLRs 200211036, 199916030. Each addition to the trust for the payment of improvements and/or mortgage payments will be gifts to the trust on which a gift tax will be owed, based on the actuarial value of the remainder interests in each payment. The gift of the remainder interest is a gift of a future interest and therefore does not qualify for the federal gift tax annual exclusion. IRC § 2503(b)(1).

4. **Estate Tax Considerations.** The term of the QPRT and the life expectancy of the grantor are important. If the grantor dies during the term of the QPRT, the entire value of the assets held in the trust are included in the grantor's estate for estate tax purposes. IRC § 2036. In that event, the value of the gift is not included in the grantor's adjusted taxable gifts, and the grantor is entitled to a credit for any gift taxes paid. IRC § 2001. Like a GRAT, no value is included in the grantor's estate if the grantor survives the term of the trust. Id. Unlike a GRAT, however, no annuity or income payments are actually made to the grantor. Instead, the interest "retained" by the grantor is the personal use of the residence itself. While this use has substantial economic value to the grantor (in the form of funds that might otherwise be spent for rental of a residence), the retained value is consumed during the term of the trust through the grantor's occupancy of the residence. Therefore, if the grantor survives the term of the trust, no economic asset is includable in the grantor's estate as a result of retaining the right to occupy the residence. Furthermore, because the residence will then be owned by the remainder beneficiaries at the end of the term, if the grantor continues to use the residence, he will need to pay rent to the new owners, thereby further reducing his estate by the rental payments. The grantor must be aware of and respect the fact that at the end of the term, the right to occupy also ends. Failure to respect this fact and the failure to pay rent if occupancy continues could result in an argument by the IRS that an implied agreement to allow the free use arrangement existed when the trust was established, thereby causing inclusion of the full value of the residence in the grantor's estate under Section 2036 of the Code. But see, *Est. of Riese v. Comm'r*, TC Memo 2011-60; *Est. of Stewart v. Comm'r*, 617 F3d 148 (2nd Cir. 2010). If the grantor is concerned about estate taxes that may arise if the grantor dies during the term of the QPRT, and if the grantor is reasonably healthy, the potential exposure can be mitigated by the use of life insurance (perhaps held by an ILIT, as discussed above). Term insurance with a term equal to the term of the QPRT could even be considered if the insurance is desired solely to provide estate tax protection.
5. **Income Tax Considerations.** A QPRT is treated as a grantor trust for income tax purposes both as to the income and corpus portions of the trust which allows the grantor to deduct expenses such as mortgage interest and real estate taxes. *See IRC §§ 671-677; PLRs 199916030, 199249014.* As a result, the capital gains exclusion available upon a sale of a residence by an individual is available for the sale of a personal residence held by a QPRT. *IRC § 121.* When the QPRT regulations were first adopted, the availability of grantor trust treatment offered an interesting planning opportunity whereby immediately prior to the termination of the QPRT, the grantor would purchase the residence from the trust. The effect would be to restore the personal residence to the grantor, while shifting substantial value to the remainder beneficiaries of the trust immediately prior to the expiration of its term. Since the trust was a grantor trust, no gain or loss was recognized at the time of the sale. However, as noted above, the Service has determined that the governing instrument for a QPRT must prohibit the sale or transfer of the residence to the grantor, the grantor's spouse, or to an entity controlled by the grantor, at any time during the retained term interest of the trust, or at any time after the original term interest during which the trust continues to be a grantor trust. A sale or transfer to another grantor trust is considered a sale to the grantor or the grantor's spouse. Treas. Reg. §§ 25.2702-5(b)(1), (c)(9).

H. **Charitable Lead Annuity Trusts**

Similar to GRATs, charitable lead annuity trusts ("CLATs") can pass most of their investment gains to heirs, while reducing or eliminating gift and estate taxes. But unlike a GRAT, which returns interest and principal to the grantor, a CLAT gives everything away, first to charity, and then typically to junior family members.

**The Technique.** Most CLATs are created by senior family members who establish a trust that provides for annual payments, typically of a fixed amount, to charity for a fixed term. Whatever is left in the trust at the end of the term is generally earmarked for junior family members. Of course, it makes little sense for a client to set up a CLAT unless he or she is charitably inclined. But for clients with charitable objectives who own assets that they expect to appreciate at rates higher than current IRS interest rates, these trusts can be better than giving the assets away outright, because they can also permit a tax-free (or at least tax-advantaged) transfer of wealth to the next generation. There is more than one way to structure a CLAT. For example, the tax treatment will vary, depending on whether the client wants to receive an upfront income tax charitable deduction. The availability of the deduction can be especially important to clients who will have a "liquidity event" (with resulting high taxes) in a single year. The trade-off, however, is that taxes payable in later years may potentially go up.

**Example 22:** Charlie, 61, sold his business this year for $10 million. He started the business years ago on a shoestring, so he has a large capital gain. In addition, part of the purchase price was for a "non-compete" agreement, which will be ordinary income to Charlie. He contributes $1,000,000 to a 20-year CLAT in July, 2017. He structures the CLAT to pay out 5% of the value of the assets initially contributed to the trust, so the CLAT will pay his favorite charity $50,000 per year for the next 20 years. Charlie was already contributing this much to charity, so he no longer needs to budget for that from his other funds. In addition to benefiting charity over the long run, Charlie gets a $802,010 income tax deduction, which goes a long way toward offsetting the income-tax bill he triggered earlier in the year. The remaining value ($197,990 in this example) will be treated as a gift by Charlie to the remainder beneficiaries of the CLAT (in his case, his children). Charlie will use part of his $5.49 million lifetime gift tax exemption, and if he has not used up his exemption, he will not have to pay gift tax on the gift to his kids. If the trust invests its assets at an average return of 8% per year, the trust will have nearly $2.4 million in it at the end of the 20th year, even after paying $50,000 per year to Charlie's favorite charity. This property will pass to Charlie's kids at a cost of only $197,990 of Charlie's gift tax exemption. One caveat that clients have to remember: As with most gifting strategies, once you put money into one of these trusts, you can't get it back. The trust has to be irrevocable to work.

Some—most famously Jacqueline Kennedy Onassis—leave instructions in their Will to create CLATs after death. But those who set them up while alive have a big advantage: They can select the most opportune moment to act. When interest rates are low, they are very attractive. The charity benefits from the annual annuity, and if the market outperforms the IRS rate over the term of the CLAT, heirs benefit too.
Estate Planning for Married Couples in a World with Portability and the Marital Deduction

Specifies.

1. Structure. In the usual case, senior family member transfers assets to the CLAT. The trust pays a fixed dollar amount to one or more charities for a specified number of years. Alternatively, the CLAT may be structured to last for the life or lives of (a) the senior family member; (b) his or her spouse; and/or (c) a lineal ancestor (or spouse of a lineal ancestor) of all of the remainder beneficiaries (or a trust in which there is less than a 15% probability that individuals who are not lineal descendants will receive any trust corpus). Treas. Reg. § 1.170A-6(c)(2)(i)(A). Unlike a GRAT (or a charitable remainder trust), a CLAT is not subject to any minimum or maximum payout. The CLAT may provide for an annuity amount that is a fixed dollar amount, but which increases during the annuity period, as long as that the value of the annuity is ascertainable at the time the trust is funded. See Rev. Proc. 2007-45, 2007-29 IRB 89. Instead of paying a fixed dollar amount, the trust can be set up to pay a set percentage of the value of its assets each year, in which event it is called a "charitable lead unitrust" or "CLUT." In inflationary times, a CLAT tends to pass more property to remainder beneficiaries than a CLUT, so a CLAT is the more common structure. The CLAT can be created during the senior family member's lifetime or upon his or her death pursuant to his or her will or revocable trust. The charity receiving payments may be a public charity or a private foundation, but in the case of a private foundation in which the grantor is involved, the grantor cannot participate in any decisions regarding the property distributed from the CLAT to the private foundation or the distribution of that property from the private foundation to the ultimate charity. In order to prevent this participation, the foundation's organizational documents should be reviewed and modified accordingly. See IRC §§ 2036(a)(2), 2038; Treas. Reg. § 25.2511-2(b); PLRs 200537020, 200138018, 200108032.

2. Gift on Formation. When the senior family member contributes assets to a CLAT, he or she makes a taxable gift equal to the present value (based on IRS tables) of the remainder interest that will pass to the non-charitable beneficiaries. IRC § 2522; Treas. Reg. §25.2522(c)-3(c)(2)(vii). As with a GRAT, this gift is of a future interest, so no annual exclusion can be used to shelter the gift tax. IRC § 2503(b)(1). Like "zeroing out" a GRAT, CLATs can be structured so that the gift or estate tax on the remainder interest will be small or non-existent. This result is accomplished simply by ensuring that the present value of the payments to be made to charity (using IRS rates at the time the trust is formed) is equal to the value of the initial contribution.

3. Setting the Interest Rate. The value of the non-charitable beneficiaries' interest is calculated using the Section 7520 rate in effect for the month that the assets are transferred to the CLAT. The transferor has the option, however, to use the Section 7520 rate in effect for either of the two months preceding the transfer. IRC § 7520(a). To make the election, the grantor attaches a statement to his or her gift tax return identifying the month to be used. Treas. Reg. § 25.7520-2(b). Because IRS rates are published around the third week of each month, the grantor in effect has the option of picking from four months of Section 7520 rates (including the rate in the current month, the preceding two months and the succeeding month).

4. Income Tax Issues. One of the most important considerations related to the structure of a CLAT is the income tax effects. If the CLAT is structured as a grantor trust for income tax purposes, then the grantor is entitled to receive an up-front income tax charitable deduction equal to the present value, based on IRS tables, of the interest passing to charity. IRC § 170(f)(2)(B). The charitable deduction is typically subject to the 30%-of-AGI deduction limitation, since the gift is treated as a gift for the use of charities. Treas. Reg. § 1.170A-8(a)(2). Beware of other limits on the income tax deduction if property other than cash, such as marketable securities, is contributed to the CLAT. See IRC § 170(e). Of course, to get this deduction, the CLAT has to be a grantor trust, which means that the grantor must pay tax on all of the CLAT's income during its term. IRC § 170(f)(2)(B). If a grantor trust structure is chosen, the grantor gets no additional deduction for amounts paid by the trust to the charity during the term of the CLAT. In addition, if the grantor toggles off grantor trust treatment, the consequence is the same as if the grantor died during the term of the CLAT, as described below. Id. If the CLAT is not structured as a grantor trust, then the grantor is not entitled to any income tax charitable deduction for amounts paid to charity. Id. Instead, the CLAT is responsible for the payment of the income taxes attributable to any income earned by the CLAT, and the CLAT receives an income tax deduction for the amount paid to charity each year. IRC § 642(c)(1).
5. **Death During Term.** If the grantor dies during the term of the CLAT, none of the trust assets will be included in the grantor's estate, since the grantor has not retained any interest in the trust. However, as noted above, estate inclusion might occur if the grantor is involved with the decisions regarding distribution of the property from CLAT to a private foundation in which the grantor is involved or distribution of that property from the private foundation to the ultimate charity. IRC §§ 2036(a)(2), 2038. See, e.g., PLR 200537020. If grantor trust treatment was used to give the grantor an initial income tax deduction, and if the grantor dies (or grantor trust treatment is otherwise terminated) during the trust term, the grantor must recapture income equal to the value of the deduction he previously received less the present value of trust income on which he paid tax, discounted to the date of contribution to the trust. IRC § 170(f)(2)(B).

6. **Benefit to Heirs.** At the end of the annuity term, the assets remaining in the CLAT pass to one or more non-charitable beneficiaries, such as the senior family member's children or other family members (or to one or more trusts for their benefit). If, over the annuity term, the CLAT generates total returns higher than the Section 7520 rate, the excess growth passes to the non-charitable beneficiaries free from any estate or gift tax.

7. **GST Tax Issues.** Unlike with a GRAT, the grantor is technically permitted to allocate a portion of his or her GST tax exemption to the CLAT at the time the CLAT is funded in an amount equal to the taxable gift. See IRC § 2632(a); Treas. Reg. § 26.2632-1(a), (b)(4). If the CLAT is structured so that the taxable gift is small or non-existent, the GST tax exemption allocated to the CLAT would be nearly zero. Unfortunately, the actual amount of GST tax exemption allocated to the CLAT is determined when the CLAT terminates. IRC § 2642(c)(1). The amount of GST tax exemption allocated upon funding is treated as growing at the Section 7520 rate in effect for the month of the funding, and not at the actual rate of growth of the trust assets. IRC § 2642(c)(2). Therefore, there is at least some adjustment to the exemption allowed. If the value of the non-charitable remainder interest exceeds the GST tax exemption initially allocated to the CLAT, as increased by the prevailing 7520 rate, the grantor can allocate any portion of his or her remaining GST tax exemption to the excess at the time the charitable interest terminates.

8. **CLATs and Business Interests.** There can be complications if the CLAT is funded with interests in a closely held entity such as a family limited partnership ("FLP"), membership units in an LLC, or (non-voting) shares in a private corporation. CLATs generally are subject to the same rules as private foundations. If the charitable portion of the CLAT is valued at greater than 60% of the fair market value of the assets contributed to the CLAT, the "excess business holding" rules will apply. IRC §§ 4943, 4947(b)(3)(A); Treas. Reg. § 1.170A-6(c)(2)(i)(D). In that case, for example, the CLAT may face an excise tax if it does not divest itself of the FLP units within five years of their contribution to the CLAT. IRC § 4943(c)(6). An attempt to sell the FLP units may prove to be difficult for the CLAT because the only willing buyers may be members of the donor's family. The rules against self-dealing (which apply even if the value of the charitable interest is less than 60% of the fair market value of the CLAT) would prevent a sale to a family member. IRC § 4941. Furthermore, if a valuation discount is applied in valuing a gift of FLP units to a CLAT, additional complications may arise if the charitable beneficiary of the CLAT is a private foundation that is controlled by the donor or his or her family. In that event, an overly aggressive discount, which substantially reduces the required annuity payments to the foundation, may be viewed as an act of self-dealing on the part of the trustees of the CLAT.

I. **Health and Education Exclusion Trusts ("HEETs")**

"Qualified transfers" for tuition and medical expenses are excluded from both gift and GST taxes if they are paid directly to the educational institution or to the medical care provider. IRC §§ 2503(e), 2611(b)(1); Treas. Reg. § 25.2503-6(a). The Section 2503(e) exclusion is in addition to the per-donee annual exclusion provided in Section 2503(b) of the Code, allowing the gift tax annual exclusion to be used for other purposes. The use of these exclusions can be an effective wealth transfer strategy. The gifts remove assets from a client's estate, free of gift, estate and GST tax, and there are no limitations as to the amount that can be paid for such expenses. Many clients wish to help with these expenses for their grandchildren or other
more remote beneficiaries. Rather than paying these expenses as they arise, a client can establish and make gifts to a trust for those beneficiaries which allows the trustee to pay the expenses. If the trust is only for these beneficiaries, i.e. skip persons, the GST tax will apply because qualified transfers from the trust are exempt from the GST tax. A Health and Education Exclusion Trust ("HEET"), or "2503(e) Trust," is a way for clients who wish to pay for their grandchildren's (and more remote descendants') education and medical bills to do so by establishing a limited purpose trust, without paying any GST tax or using any GST tax exemption.

**The Technique.** A HEET is a type of trust whereby the grantor establishes a trust for the benefit of beneficiaries who are at least two generations younger than the grantor and makes gifts to the trust of cash or other assets. The trustee is authorized pursuant to Section 2503(e) of the Code to directly pay qualified education and medical expenses of the beneficiaries. Although gifts to a HEET are subject to gift tax (unless the trust can be drafted so that gifts to it qualify as present interest gifts), a major advantage of a HEET is that, when properly structured, it is not subject to the 40% GST tax. If second generation (or more remote beneficiaries) are the only beneficiaries of the HEET, transfers funding the HEET would be a direct skip, requiring the payment of GST tax or use of the client's exemption, which would then be wasted when qualifying distributions were later made. Therefore, the HEET must have a non-skip person (often a charity) as one of its beneficiaries. In summary, a HEET is best suited for clients who have estates in excess of the available GST tax exemption, who intend to provide for beneficiaries who are more than one generation younger than them, and who have charitable goals.

**Specifics.**

1. **Structure.** A HEET is generally intended as a trust for the benefit of second generation and other more remote beneficiaries. The terms of the HEET must limit the authority of the trustee to make distributions to non-charitable beneficiaries only in a manner that constitute "qualified transfers" within the meaning of Section 2503(e) of the Code (and thereby, Section 2611(b)(1)). The trust is structured with at least one non-skip beneficiary (e.g., a charity). As a result, a transfer to a HEET is not a direct skip. IRC § 2612(c)(1). Because the trust itself is not a skip person, the GST exposure is limited to taxable distributions and terminations. IRC § 2611(a). If the HEET were to make distributions directly to grandchildren or more remote descendants, either during the term of the trust or upon termination, the trust would pay GST tax. IRC §§ 2612(a), (b). However, the trustee of the HEET is instructed to make only "qualified transfers" for tuition or medical expenses for the benefit of those descendants, paid directly to the educational institution or to the medical care provider. Since those distributions are excluded as gifts and therefore generation-skipping transfers, the distributions made on behalf of a skip person are not subject to the GST tax. IRC § 261(b)(1).

2. **Educational Expenses.** The Section 2503(e) exclusion applies to tuition paid to an educational organization described in Section 170(b)(1)(A)(ii) of the Code for the education or training of an individual. Treas. Reg. § 25.2503-6(a). The exclusion provided in Section 2503(e) is not available for amounts paid for books, supplies, dormitory fees, board, or other similar expenses that do not constitute direct tuition costs. Treas. Reg. § 25.2503-6(b)(2). In addition, the Section 2503(e) exclusion is not available for payments to Section 529 plans, but those contributions are generally already exempt from GST tax under the terms of Code Section 529 itself. See IRC §§ 529(c)(2)(A)(ii), (c)(5).

3. **Educational Organizations.** An "educational organization" is one that normally maintains a regular faculty and curriculum and has a regularly-enrolled body of students in attendance at the place where its educational activities are carried on regularly. It also includes primary, secondary, preparatory, and high schools, colleges, universities, and other qualifying organizations whose primary purpose is providing education, whether domestic or foreign. IRC § 170(b)(1)(A)(ii); Treas. Reg. § 1.170A-9(c)(1) (redesignated by TD 9423, 73 Fed. Reg. 52528 (9/9/08). The exclusion applies only to

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57 A client may not have children, and thereafter, grandchildren. The point is that the beneficiaries are at least two generations below the grantor.

58 See IRC § 2611(b)(1), which provides that any transfer which, if made inter vivos by an individual, and would not be treated as a taxable gift by reason of IRC § 2503(e) (relating to exclusion of certain transfers for educational or medical expenses) is excluded from the definition of a generation-skipping transfer.
tuition expenses of full-time or part-time students paid directly to the qualifying educational institution providing the education. Treas. Reg. § 25.2503-6(b)(2), (c), Ex. 1. As a result, the exclusion is not available for tuition expenses paid by the student to the educational institution that are then reimbursed by the trustee to the student. Advance and non-refundable payments for future school years, made directly to a private school to be used exclusively for tuition costs of designated individuals, are also excludable under Section 2503(e). See, e.g., TAM 199941013; PLR 200602002.

4. Medical Expenses. The Section 2503(e) exclusion also applies to amounts paid on behalf of a donee directly to a provider for medical care. IRC § 2503(e)(2)(B); Treas. Reg. § 25.2503-6(b)(1)(ii), (b)(3), (c), Ex. 3. As with educational expenses, the exclusion is not available for medical expenses previously paid by the donee that are then reimbursed, whether by the trustee to the beneficiary or by insurance. Treas. Reg. §§ 25.2503-6(b)(3); 25.2503-6(c), Ex. 4. See also, Rev. Rul. 82-98, 1982-1 CB 141. The term "medical care" is defined by reference to amounts eligible for an income tax deduction under Section 213(d) of the Code. IRC § 2503(e)(2)(B). The exclusion is thus available for amounts paid for: (1) the diagnosis, cure, mitigation, treatment or prevention of disease; (2) the purpose of affecting any structure or function of the body; or (3) transportation primarily for and essential to medical care. Treas. Reg. § 25.2503-6(b)(3). Examples of covered payments include those for hospital services, nursing care, medical laboratory, surgical, dental and other diagnostic services, x-rays, medicine and drugs (whether or not requiring a prescription), artificial teeth and limbs, and ambulance. Importantly, the exclusion is available for payments of medical insurance paid on behalf of an individual. Treas. Reg. § 25.2503-6(b)(3). See also Rev. Rul. 82-98, 1982-1 CB 141. Therefore, a HEET can be used to provide medical and long-term care insurance for its beneficiaries. Id.; IRC §§ 213(d)(1)(D), (d)(10).

5. Non Qualified Transfers. As noted above, distributions that constitute a "qualified transfer" include payments of tuition for full or part-time students to qualified educational organizations. However, other educational expenses (such as the costs of books and room and board) do not qualify (although they may qualify for payments from a Section 529 plan). Expenses that don't qualify as medical expenses are payments for most cosmetic surgery or other similar procedures, except those that correct a deformity resulting from a congenital abnormality, a personal injury, or a disfiguring disease. IRC § 213(d)(9)(A).

6. Gift Tax Issues. As mentioned, a HEET does not directly avoid application of the gift tax. The Section 2503(e) gift tax exclusion is only for qualified transfers made directly to qualified educational organizations and medical providers. If funds are transferred by a donor to a trust providing for distributions to be made by the trustee for tuition expenses incurred by a trust beneficiary, the transfer is not a direct transfer by the donor to an educational organization or medical provider, and therefore does not qualify for the Section 2503(e) exclusion. Treas. Reg. § 25.2503-6(b)(2), (c), Ex. 2. On the other hand, a transfer from such a trust in payment of tuition and medical expenses does qualify for the Section 2611(b)(1) exclusion from the GST tax. IRC §§ 2611(b)(1); 2642(c)(3)(B); see also PLR 200602002. The contribution of funds to the HEET will be a taxable gift. If the grantor does not have any remaining applicable exemption amount, the contributions will require the payment of gift tax. As a result, the grantor may seek to leverage the amount ultimately held by the HEET by contributing discounted or rapidly appreciating assets. If the grantor's goal is to provide for grandchildren or more remote beneficiaries after the grantor's death, the trustee of the HEET may acquire and maintain insurance on the life of the grantor as an (or the only) investment of the trust. Alternatively, the grantor may choose to create a testamentary HEET or added funds to an existing HEET at the time of the grantor's death.

7. GST Tax Issues. Generation-skipping transfers can arise by way of a direct skip, a taxable distribution, or a taxable termination. IRC § 2611. A "direct skip" may arise from a transfer made directly to a skip person (e.g., a grandchild), either during lifetime or at death. IRC 2612(c). In addition, a transfer made to a trust in which all beneficiaries are "skip persons" is also a direct skip. IRC § 2651(f)(2); Treas. Reg. § 26.2612-1(a). Transfers to trusts that have both skip and non-skip persons as beneficiaries are not subject to the GST tax upon the funding of the trust, since the transfers aren't direct skips. IRC § 2612(c)(1). A charity is not a skip person, since by statute it is assigned to the same generation as the grantor. IRC § 2651(f)(3). Therefore, a gift to a HEET that includes a charity as a beneficiary prevents the application of the deemed allocation rule under Section 2632(b).
A taxable termination occurs when a trust terminates and makes distributions to skip persons, or if earlier, when the trust loses its last non-skip-person beneficiary and, therefore, only skip persons remain as beneficiaries. IRC § 2612(a); Treas. Reg. 26.2612-1(b). Therefore, it is essential that the HEET always have a non-skip person as a beneficiary. Because charitable beneficiaries typically have perpetual lives, naming one or more charities as remainder beneficiaries of the trust should ensure that a taxable termination will never occur, so that GST tax will not be paid upon the trust's termination.

GST tax might also be payable when a distribution is made from the trust. A taxable distribution occurs when a distribution is made to a skip person. IRC § 2612(b). If the HEET is drafted to allow distributions for reasons broader than qualified transfers, a danger arises that a distribution might be made to or for the benefit of a skip person, which would then incur GST tax. If broader distributions from the trust are permitted, it is likely that upon funding, the trust would be characterized as a GST trust and the deemed allocation rule of Section 2632(c) of the Code would apply unless the transferor opts out of having the rule apply pursuant to Section 2632(c)(5) of the Code.

8. Significant Interest. To avoid GST exposure, the interest of the non-skip person must not be an interest designed "primarily to postpone or avoid" the GST tax. IRC § 2652(c)(2). As a result, the charity's interest must be significant. The more meaningful the charity's interest, the greater the likelihood the IRS will respect it. On the other hand, the larger the payout to charity, the less property is available for the non-charitable beneficiaries. Unfortunately, there is little guidance in this area. Some practitioners believe a 10% unitrust amount should be paid annually to the charity. Others believe that a 4% to 6% annual unitrust amount is significant and cannot be ignored and treated as de minimis. Still others believe that between 10% and 50% of the HEET's income should be paid to the charity annually, plus a percentage of trust principal. Many practitioners take comfort in guidance found under several provisions of the Code that posit that a 5% or greater economic interest is deemed to be significant. Until the IRS provides guidance on this issue, uncertainty will remain.

Caution is warranted to avoid application of the separate share rule under Section 2654(b)(2) of the Code. If the charity's interest is treated as a separate share, the HEET could be separated into two trusts, one for the benefit of the charity and the other exclusively for the non-charitable beneficiaries. IRC § 2654(b). The IRS could treat this as a taxable termination, subjecting most of the assets of the HEET to the GST tax. Separate share treatment may be avoided by giving the trustee the discretion to make payments of income and principal to the charity, but with a defined "floor." The uncertainty as to what the charity will receive should avoid the application of the separate share rule, while the floor helps assure that the charity's interest is significant.

9. Income Tax Issues. Because a HEET provides discretionary benefits to non-charitable beneficiaries, there is generally no up-front income or gift-tax charitable deduction available to the grantor when the grantor establishes an inter vivos HEET, nor is an estate tax charitable deduction available for assets funding a testamentary HEET. IRC §§ 170(f)(2)(B); 2055(e)(2)(B); 2522(c)(2)(B). If the grantor wishes to obtain an income tax deduction for income passing to charity, one option is to consider drafting an inter vivos HEET as a "grantor trust" so that, when the HEET makes distributions to charity, the grantor will be entitled to an annual charitable income tax deduction. See IRC § 671. Since the grantor of the HEET pays the tax on the HEET's income, a grantor HEET also adds benefits to the beneficiaries, because the growth of the HEET's corpus is not diminished by income taxes. A testamentary HEET will be taxed as a complex trust (as will an inter vivos non-grantor HEET, and an inter vivos grantor HEET after the grantor's death). If the HEET is a complex trust, it will be required to file its own income tax return. In that case, the trust itself will deduct distributions made to the charitable beneficiary to the extent that they are paid from the trust's gross income. IRC § 642(c). In addition, if a charity is not entitled to and does not receive distributions from the trust, the trust's income will be reported to the other trust beneficiaries to the extent that distributable net income ("DNI") is distributed to them or on their behalf. IRC §§ 661, 662. If a distribution was in turn made to or on behalf of those beneficiaries who are skip persons that is not a

59 See, Goff, An Introduction to Lesser-Known But Useful Trusts—Part 1, 37 EST. PLAN. 7 (2010). See also, e.g., IRC § 4942 (minimum distribution amount for private foundations); IRC § 664 (minimum distribution amount for charitable remainder trusts); IRC § 2041(b)(2) (lapse of power of appointment); IRC § 147 (private activity bonds).
qualified transfer, such as a distribution to cover their income tax obligations (or allocating the trust's estimated tax payments to the beneficiaries), GST tax will be imposed. IRC § 2612(b).

10. Uses for HEETs. A HEET may be used as part of the client's estate plan for assets in excess of the GST exemption. For example, after the decedent's GST exemption is allocated to lifetime trusts for children, a portion of the remaining estate could be allocated to a HEET for grandchildren and more remote descendants. Clients might also consider establishing an inter vivos HEET using annual exclusion gifts or their lifetime gift tax exemption. Alternatively, a testamentary HEET can be established in the client's will or revocable trust, to be funded at the time of the client's death (presumably with assets not otherwise exempt from the GST tax). Of course, assets used to fund a testamentary HEET would be subject to estate taxes but those assets (and their income) may effectively avoid the GST tax. In addition, an inter vivos HEET might be a feature of an irrevocable life insurance trust ("ILIT") drafted as a HEET.

Clients with charitable objectives might divide the charitable portion of their estate between a family foundation or a donor-advised fund and a HEET. The family foundation or donor-advised fund could also serve as the charitable beneficiary of the HEET. While contributions to a HEET are ineligible for income, gift and estate tax charitable deductions, they nevertheless benefit the charity while achieving important goals for the client's youngest descendants, without the imposition of GST taxes.

An important planning opportunity involves naming a HEET as the remainder beneficiary of a grantor retained annuity trust ("GRAT"). Because of the estate tax inclusion period ("ETIP") rules, in most cases GST tax exemption cannot effectively be allocated to a GRAT until the end of the GRAT term. Treas. Reg. § 26.2632-1(c). Thus, if the GRAT increases in value as planned, that appreciation would be partially subject to GST taxes if the remainder beneficiaries were skip persons. However, by making a HEET the GRAT's remainder beneficiary, the remainder interest can benefit skip persons without any GST tax exposure. A HEET could also be used in conjunction with a charitable lead annuity trust ("CLAT"). While the rules for allocating GST tax exemption to a CLAT differ from the ETIP rules for a GRAT, they still largely prevent a grantor from effectively allocating GST tax exemption to ensure a zero inclusion ratio for the remainder interest at the time the charity's interest in the CLAT terminates. See Treas. Reg. § 26.2642-3. As with a GRAT, a HEET remainder beneficiary does away with the GST tax exemption concern.

11. Greenbook Concerns. The Obama Administration's 2017 budget proposal (sometimes referred to as the "Greenbook") included several significant proposed changes to the taxation of estates, gifts, and trusts. One of those proposals (first included in 2014) was directly aimed at HEETs. The proposal sought to "clarify" that the Section 2611(b)(1) exclusion applied only to a direct payment by a donor to the provider of medical care or to the school in payment of tuition, and not to trust distributions, even if the distributions are made for those same purposes. The proposal would have applied to trusts created after the introduction of the bill proposing this change, and to transfers made to trusts after that date that are otherwise protected by the effective date rules. Curiously, unlike other estate and trust proposals, the elimination of HEETs was projected to decrease tax collections by $231 million between 2016 and 2025 (presumably in the form of lost gift or estate tax).

J. Self-Cancelling Installment Notes

What if your client may not survive to his or her actuarial life expectancy? People in this unfortunate situation may consider selling assets (especially undervalued assets) to a junior family member. If a simple note is given for the purchase price, the potential to move appreciation is the same as for other transactions discussed above. But where life expectancy is an issue, the payment given in exchange for the asset can

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60 See U.S. Treasury, General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals, (February 2016), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf. The current administration issued its budget "blueprint" on March 16, 2017, but it contains no specific discussion of proposed tax law changes. As of the date of this article, a detailed budget proposal from the current administration has not been published.
take the risk of death into account. The most popular forms of payment in these circumstances are self-cancelling installment notes ("SCINs") and private annuities (discussed below).61

The Technique. As its name suggests, a self-cancelling installment note is a promissory note providing that if the seller/lender dies before the note is paid in full, any unpaid amounts are cancelled. The seller's death during the term of the note creates a windfall to the buyer because he or she won't have to make any further payments on the note, regardless of the amount of the outstanding balance. To compensate the seller for the risk of losing money because of an early death, a SCIN must provide a "kicker," in the form of extra interest, extra principal, or both, that will be received if the seller survives. Since the buyer's obligation to make any future payments on the note is cancelled upon the seller's death, no value is included in the seller's estate for any unpaid amounts. Of course, the amounts received by the seller during his or her lifetime (to the extent not consumed, given away, or otherwise disposed of) will be included in the seller's estate. The IRS publishes life expectancy tables that have traditionally been used to value the SCIN premium, so long as the seller isn't "terminally ill." For caution in using this presumed valuation method, see CCA 201330033 and the IRS petitions in the Davidson case, cited below. The buyer can be a junior family member or an IDGT.62

Example 23: In January 1995, Scott, then age 70, was not terminally ill but was not expected to live for his actuarial life expectancy. Scott sold FLP units having an undiscounted value of $10,000,000 and a discounted value of $7,000,000 to an IDGT for the benefit of his children and grandchildren in exchange for a 9-year, interest-only SCIN. Scott died at the beginning of year 8 of the 9-year term, when the FLP assets had appreciated to $20,000,000 (or roughly 10.4% per year, compounded annually). Assuming that Section 7520 of the Code applies to value the note (but see the discussion regarding the Davidson case below), the required interest rate on the SCIN, including the mortality risk premium, was 13.864%, corresponding to an annual interest payment of $970,480. Over the first 7 years of the SCIN, the trust paid Scott a total of $6,793,360 in interest payments. The remaining $13,206,640 of value of the FLP units was retained by the IDGT without any gift or estate tax inclusion in Scott's estate. If, instead, this transaction had occurred in July, 2017, the required interest rate on a SCIN for a 70-year-old, based on the Section 7520 rate and including the mortality risk premium, would have been 5.76%, corresponding to an annual interest payment of only $403,200. Over the first 7 years of the SCIN, the trust would have paid Scott a total of $2,822,400 in interest payments. The remaining $17,177,160 of value of the FLP units (roughly $4 million more than that in the prior example) would have been retained by the trust.

Specifics.

1. SCIN Terms. A SCIN is similar to a sale of assets for a traditional promissory note. The note could be structured with regular amortizing payments, or with payments of interest only with a balloon payment due upon maturity (although the interest-only structure is more aggressive planning). In the case of a SCIN, however, the note terminates upon the earlier of the note's maturity date or the senior family member's death. If the senior family member dies before the maturity date, the maker's obligation to pay any remaining outstanding principal on the note is cancelled, and no additional payments are due.

2. Risk Premiums. Because the buyer's obligation to pay back the note could terminate on the senior family member's death during the note term, a mortality risk premium must be charged. This risk premium can take the form of a higher interest rate, a higher principal for the note, or both. In any event, the exact amount of the premium is presumably determined by the senior family member's life expectancy (presumably actuarially based on IRS tables, although the IRS disagrees). The older the senior family member is, the higher the risk premium must be. If a premium is not paid, the transaction may constitute a bargain sale, resulting in a gift from the senior family member to the buyer. See Costanza Est. v. Comm'r, 320 F3d 595 (6th Cir. 2003). Note that while most commentators presume that the premiums for SCINs should be based upon IRS actuarial tables, there is no express authority for this proposition. The

61 For a detailed on both of these techniques, see Akers, SCINs and Private Annuities: Disappearing Vale or Disappearing Strategies?, 49 U. MIAMI HECKERLING INST. ON EST. PL. ¶ 606 (2015).
IRS has recently taken the litigation position that those tables may not apply when valuing a SCIN, even if the taxpayer's actual life expectancy is within the safe harbor for use of those tables, discussed below. The IRS has argued that (i) the notes may not be valid notes if the buyer may lack the wherewithal to pay the note plus a substantial SCIN premium; and (ii) the Section 7520 valuation tables do not by their terms apply to promissory notes, and instead a willing-buyer willing-seller standard must be used to value the notes, based upon the seller's actual medical history on the date of the gift.63 See CCA 201330033; Davidson v. Comm'r, Tax Ct. Docket No. 013748-13. On July 16, 2015, by stipulated decision filed in the Tax Court, the Davidson case settled, so no comfort as to how the premiums are to be calculated will be forthcoming for the foreseeable future.64

3. Death Before Maturity. If the senior family member dies prior to the SCIN's maturity date, any unpaid principal or accrued interest is not includible in his or her estate because of the bargained-for nature of the risk premium and corresponding cancellation provision. Est. of Moss, 74 TC 1239 (1980), acq. in result in part 1981-2 CB 2. On the other hand, if the senior family member lives until the note fully matures, he or she will receive not only the full payment price, but also the interest or purchase price premium. While Code Section 61(a)(12) generally treats debt forgiveness as income to the borrower, forgiveness of indebtedness that takes the form of an inheritance is an example of the "detached and disinterested generosity . . . affection, respect, admiration, charity or like impulses" that characterize a gift excludable from the recipient's income. See Comm'r v. Duberstein, 363 US 278, 285 (1960). It is well settled that cancellation of a debt can be the means of effecting a gift. See, e.g., Helvering v. American Dental, 318 US 322 (1943). A testamentary cancellation of a debt owing to the decedent can similarly be the means of effecting a gift in the form of a bequest. TAM 9240003. However, the 8th Circuit has held that the cancelled debt is IRD and is taxable as gain to the estate of the payee upon the death of the note holder, which presumably is the position that the IRS would take in this circumstance. Est. of Frane v. Comm'r, 998 F2d 567 (8th Cir. 1993). With many techniques that have potential estate tax inclusion issues, clients can mitigate against that risk by purchasing life insurance (often owned by an ILIT, as discussed above). As noted immediately below, however, the typical candidate for a SCIN is a senior family member with a shortened life expectancy. Nevertheless, if the client is healthy enough to do so, the risk of estate tax exposure arising from collecting the interest or principal premium can be mitigated by the use of life insurance. In fact, the client might spend all or part of the increased payments associated with the SCIN premium on insurance. Note, however, that unlike the risks associated with GRATs and QPRTs, the risk in a SCIN is that the client will live "too long" and not that the client will die "too soon." Thus, if the client chooses to maintain life insurance for this purpose, a permanent insurance policy (as opposed to term insurance) is likely a better choice.

4. Impact of Life Expectancy. SCINs work best when the senior family member is not expected to live for the duration of his or her life expectancy, provided that he or she is not "terminally ill." Even if Section 7520 otherwise applies, if the senior family member is terminally ill, the standard mortality tables of Section 7520 may not be used. Treas. Reg. § 25.7520-3(b)(3). As a safe harbor, the Treasury regulations provide that an individual is terminally ill if he or she has at least a 50% chance of dying within one year. Id. However, the taxpayer benefits from a rebuttable presumption that the individual is not terminally ill if he or she lives for at least 18 months after the date of the SCIN. Id. When in doubt, or in an abundance of caution, obtain a letter from the senior family member's primary physician, confirming the health of the client. As noted above, while most commentators assume that the premiums for SCINs should be based upon IRS actuarial tables, there is no express authority for this proposition. As also noted above, the IRS has recently taken the litigation position that those tables do not apply to value a SCIN, even if the

63 Section 7520 provides that the tables may be used to determine "the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest."

64 Two months following the stipulated decision, the personal representatives of the Estate of William M. Davidson and trustees of the William M. Davidson Trust filed suit against Deloitte Tax LLC in New York Supreme Court under Index No. 653203/2015 for the "reckless and grossly negligent estate and tax plan" which included the SCIN planning. That case is still pending.
taxpayer's actual life expectancy is within the safe harbor described above. See CCA 201330033; Davidson v. Comm'r, Tax Ct. Docket No. 013748-13.

5. Impact of Interest Rates. As the example above illustrates, like traditional intra-family loans, SCINs work best when interest rates are low. In a low interest rate environment, the interest rate on a SCIN, including the mortality risk premium, can be significantly lower than even a traditional note in a high interest rate environment. Likewise, a SCIN's benefits can be amplified when used in conjunction with a sale of discounted or appreciating assets, such as limited partnership units in an FLP, membership units in an LLC, or (non-voting) shares in a private corporation, to an intentionally defective grantor trust. The level of amplification may be lowered in the future once the recently released proposed regulation regarding Section 2704 become final. A discussion of these proposed regulations is below.

K. Private Annuities

Estate planners often consider another option for clients who are perhaps not expected to survive to their actuarial life expectancy. Instead of transferring assets in exchange for a note (self-cancelling or otherwise), these clients may consider selling assets to a junior family member in exchange for a promise to make an annuity payment for the lifetime of the senior family member, or for a period of years likely to exceed the actual life expectancy of the senior family member. Most insurance companies offer commercial annuities that make these sorts of payments. When the payor of the annuity is a private person (typically, a junior family member), the payment obligation is referred to as a private annuity.

The Technique. A private annuity is similar to a self-cancelling installment note arrangement. Instead of giving a note, the buyer promises to make a fixed annual payment to the seller for life, no matter how long the seller lives. Since the annuity payment obligation terminates at death, no value is included in the seller's estate for any unpaid amounts. Of course, the amounts received by the seller during his or her lifetime (to the extent not consumed, given away, or otherwise disposed of) will be included in the seller's estate. The IRS publishes life expectancy tables that can be used to value the private annuity, so long as the seller isn't "terminally ill." No mortality premium is required. As is the case with the SCIN, the buyer can be a junior family member, or an IDGT. Because of proposed Treasury regulations issued in 2006 and the impact on the income tax issues associated with private annuities, an IDGT may be the preferred choice as an issuer of a private annuity. Prop. Treas. Reg. Prop. §§ 1.1001-1(j), 1.72-6(e).

Example 24: In January 1995, Patrick, then age 70, sells FLP units having an undiscounted value of $10,000,000 and a discounted value of $7,000,000 to an intentionally defective grantor trust for the benefit of his descendants in exchange for a lifetime private annuity. Patrick dies 9 years later, when the assets held by the FLP have appreciated to $18.7 million (roughly 7.2% per year, compounded annually). In 1995, the applicable interest rate would have been 9.6%, requiring the trust to pay Patrick $1,067,399 annually. Over the 9-year term of the annuity, Patrick would have received a total of $9,606,591 in annuity payments. The remaining $9.1 million of value would have been retained by the trust. If, instead, the sale had taken place in July, 2017, the applicable interest rate would have been 2.2%, requiring the trust to pay Patrick only $600,045 per year. Over the 9-year term of the annuity, Patrick would have received only $5,400,401 in annuity payments, leaving nearly $13.3 million in value in the trust (about $4.2 million more than in the prior example).

Specifics.

1. Structure. A private annuity works much like a SCIN. The senior family member transfers assets to a junior family member in exchange for junior's promise to make fixed payments to senior for the remainder of senior's life. Because the annuity terminates upon the senior family member's death, it is not includable in his or her estate. For gift tax purposes, the value of the annuity payments is based on the Section 7520 rate and the senior family member's life expectancy. Treas. Reg. § 1.7520-1. If the fair market value of the assets transferred from senior to junior equals the value of the annuity, there is no gift tax due. Taxpayers have assumed that IRS mortality tables made be used for a SCIN, but as discussed above, this is not a belief held by the IRS. With a private annuity, Treasury regulations expressly provide

that the standard mortality tables of Section 7520 of the Code may be used, provided that the taxpayer is not "terminally ill." Treas. Reg. § 25.7520-3(b)(3). As explained above with a SCIN, the Treasury regulations provide that an individual is terminally ill if he or she has at least a 50% chance of dying within one year, but there is a rebuttable presumption that the individual is not terminally ill if he or she lives at least 18 months after the transfer. Id. To overcome any issues regarding whether the senior family member was terminally ill at the time of the transaction, it would be important to obtain a letter from the doctor to that effect.

2. **Income Taxation of Annuity Payments.** Until fairly recently, the IRS treated a private annuity much like a SCIN for income tax purposes, with the senior family member reporting any gain ratably over the annuity term. See IRC § 72; see also Rev. Rul. 69-74, 1969-1 CB 43. However, under proposed regulations, the ratable recognition approach is not available in the context of a sale for a private annuity. Instead, for annuity contracts received after October 18, 2006, the senior family member is required to recognize gain at the time the assets are transferred in exchange for the annuity. Prop. Treas. Reg. § 1.1001-1(j). Treas. Reg. § 1.451-1(a). Note, however, that these regulations are merely proposed, and are not binding on taxpayers until they become final. Note also that if the assets are sold to a grantor trust, no gain is recognized on the sale. See Rev. Rul. 85-13, 1985-1 CB 184.

3. **The Exhaustion Test.** Treasury regulations include a unique requirement for private annuities. In general, the regulations don't allow the use of a standard Section 7520 valuation of the annuity stream if the annuity is payable from a trust, partnership, or other limited fund for the lifetime of one or more individuals unless, using the Section 7520 interest rate at the valuation date of transfer, the fund is sufficient to make all required annuity payments until the annuitant reaches age 110. Treas. Reg. §§ 1.7520-3(b)(2)(i), 20.7520-3(b)(2)(i), 25.7520-3(b)(2)(i). In other words, in order to value a private annuity under Section 7520, the annuity must meet this exhaustion test. This rule has the practical effect of either limiting the annuity term so that it doesn't exceed the term that would exhaust the trust, or "overfunding" the trust so that it holds a cushion of assets sufficient to continue payments until the transferor reaches age 110. Historically low interest rates and a $5+ million gift tax exemption make it easier for senior family members to make gifts to the payor trust to use the latter strategy of overfunding to meet the exhaustion test.

4. **Estate Tax Exposure.** If the amount of the annuity closely approximates the income or cash flow from the transferred asset, especially if the only way to make the payments are from the transferred assets, the IRS might argue that in effect, the senior family member made a transfer of assets while retaining the right to the income from the property, which would cause the transferred property to be included in the estate of the senior family member under Section 2036 of the Code. See Rev. Rul. 68-183, 1968-1 CB 308 (transfer of stock paying a $40x-per-year dividend in exchange for a $40x-per-year annuity for life constitutes a transfer with a retained right to income requiring inclusion of the transferred stock in the estate of the transferor at death under Section 2036); Fidelity-Philadelphia Trust Co. v. Smith, 356 US 274 (1958); Weigl v. Comm'r, 84 TC 1192 (1985) (grantor of trust had not entered into a bona fide annuity transaction with trust and was therefore taxable on trust income pursuant to grantor trust rules); Trombetta v. Comm'r, TC Memo 2013-234. See also, Rev. Rul. 79-94, 1979-1 CB 296. In order to avoid the application of Section 2036, estate planners typically suggest that the transaction expressly (i) requires that the annuity payments be made without regard to whether the property transferred produces income (perhaps including a personal guarantee by trust beneficiaries where the transferee is a trust); (ii) provides for an annuity payment that is substantially different from the amount of income produced by the transferred property; and (iii) arranges for the transferee to have assets in addition to those transferred in exchange for the annuity promise to ensure "coverage" for the annuity payments. Again, a large federal gift tax exemption makes fulfilling these requirements more palatable for many clients.

5. **Outliving the Tables.** Unlike a SCIN, the payments under a private annuity need not end at a fixed maturity date (so long as the exhaustion test is met), but may be extended for the client's lifetime. This continuation of payments may be a comfort to clients who are concerned about giving away "too much," and not retaining enough to support themselves for the rest of their lives. But like a SCIN, a private annuity poses an estate tax risk that the payments made will actually add value to the senior family member's estate if he or she lives to maturity. In fact, if the private annuity is structured to require payments for the lifetime of the transferor, and if the senior family member lives well beyond his or her life expectancy,
these additional payments can add substantial value (and taxable income) to the recipient's estate. One way to guard against this possibility might be to structure the private annuity to last for the shorter of a term of years or life. Another option would be to structure the private annuity as a deferred annuity which would begin annuity payments after a specified time, realizing that those payments would be larger than if they began immediately; however, it may be difficult to meet the exhaustion test using this structure. In addition, if the deferral is too long, especially in light of the annuitant's health, the IRS might view the private annuity to be abusive. See Kite v. Comm'r, TC Memo 2013-43. As with a SCIN, if the client's health permits, he or she may choose to hedge the risk of increased estate tax inclusion through the purchase of life insurance (typically owned by an ILIT, as discussed above). Also like a SCIN, the client may use all or part of the payments received to pay for these insurance premiums, and should consider using a permanent (as opposed to a term) insurance product.

6. Best Time for Private Annuities. Like SCINs, private annuities can be used in conjunction with a sale of appreciating assets, such as limited partnership units in an FLP, membership units in an LLC, or (non-voting) shares in a private corporation, to an intentionally defective grantor trust. They work best when interest rates are low because the annuity payments required to be made by the buyer to the senior family member will be lower, thereby allowing the trust to retain more of the transferred assets at no transfer tax cost to the senior family member.66


L. The Preferred Partnership "Freeze"

An ownership interest in a business enterprise is actually a bundle of rights. These rights include the right to vote, receive dividends, receive assets upon liquidation, and participate in the future appreciation in the value of the company. By creating separate classes of ownership interests, these rights can be segregated into classes of stock (or partnership interests) that feature each of these rights separately. For example, a business owner might recapitalize a closely held company to isolate the voting control, income and current value in one class of "preferred" stock, leaving only the right to future appreciation in the "common" stock. In 1990, Congress wrote some elaborate valuation rules that changed the way this type of business interest is valued if "junior interests" (the common stock) are transferred to younger family members, while "senior interests" (the preferred stock) are retained by senior family members. IRC § 2701(a). In the economic and legal climate of the 1990s, these rules, set out in Chapter 14 of the Code, had their intended effect of inhibiting the use of "preferred interests" as wealth shifting tools. In the current climate, however, this strategy (now typically achieved using limited partnerships instead of corporations) may once again merit consideration.

The Technique. Unlike a conventional limited partnership with a single class of limited partners, a preferred partnership is typically created by the senior family member contributing assets to a partnership that has at least two classes of limited partnership interests. One class provides the holder with a preferred right to receive distributions of income and liquidation proceeds, much like traditional preferred stock. The other class (the common interest) gets any return above the preferred return, and receives liquidation proceeds only after creditors and the preferred holders are paid in full. The economic consequence of this structure is that the holder of the preferred partnership interest can never receive more than the annual preferred payments of income, and its liquidation preference. Any other income, cash-flow, liquidation proceeds or other return belongs to the holders of the common partnership interests. The senior family member might then (i) give the preferred interest to a GRAT or CLAT; and/or (ii) give all or a portion of the common interest to junior family members (or to a trust or IDGT for their benefit). If the junior family members (or trust) have assets of their own, they might contribute those assets directly to the partnership in exchange for common partnership interests. If properly structured, the common limited partnership interests will be valued based not only upon discounts for lack of control and lack of marketability (although discounts in the future may not be as great depending on the fate of the recently released proposed regulations regarding Section 2704, a discussion of which follows), but will also have their value reduced by the value of the preferred partnership interest.
Example 25. Fred places $10,000,000 worth of stocks, bonds, real estate, and other holdings into a limited partnership which (in addition to a 1% general partnership interest retained by Fred), provides for two classes of limited partnership interests. The preferred interest is entitled to receive the first $350,000 of partnership distributions made in any year. Any partnership distributions in excess of $350,000 per year are paid to the common partnership interest owners. If partnership distributions are less than $350,000 in any year, the unpaid amount is carried forward as a preference owed to the holders of the preferred interest in future years. In addition, when the partnership liquidates, the preferred owners are entitled to receive the first $5,000,000 worth of liquidation proceeds, with any excess passing to the holders of the common interests. If the assets in the partnership grow at 10% per year for fifteen years, the holders of the preferred interest would receive $350,000 per year, plus $5,000,000 upon the liquidation of the partnership, while the holders of the common interest would be entitled to receive the balance of the partnership assets, over $25,652,000. The preferred interests are effectively "frozen" in value at $5,000,000 while the common interests enjoy the balance of the growth.

Specifics.

1. **Structure.** Section 2701 of the Code provides that when a person transfers an interest in a corporation or limited partnership to a "member of the transferor's family" (generally, the transferor's spouse, descendants of the transferor or transferor's spouse, or the spouses of those descendants), certain rights retained by the transferor must be valued at zero. IRC § 2701(a)(3). These "applicable retained interests" include (i) any distribution right if, immediately before the transfer, the transferor and "applicable family members" have control of the entity; and (ii) a liquidation, put, call or conversion right. IRC § 2701(b)(1). For purposes of the control test, "applicable family members" mean the transferor's spouse, ancestors of the transferor or spouse, a spouse of those ancestors, or any descendants of a parent of the transferor or transferor's spouse. IRC § 2701(e)(2). Valuation of the retained payment rights at zero is problematic, because the Treasury regulations generally require any gift of an interest in the corporation or partnership to be valued at the value of all interests held before the gift, less the value of the interests retained by the transferor. Treas. Reg. § 25.2512-5(d)(2). Fortunately, there are several exceptions to the rules requiring a zero valuation, and the preferred partnership takes advantage of these exceptions. Two notable exceptions are available to estate planners. First, the valuation rules of Section 2701 generally do not apply if the transferor gives away the preferred interest and retains the common interest. IRC § 2701(c)(1)(B)(i); Treas. Reg. § 25.2701-2(b)(3)(i). Second, a preferred interest will not be valued at zero so long as the preferred rights retained by the transferor are rights to a "qualified payment." IRC § 2701(a)(3)(A). A "qualified payment" means a dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under a partnership agreement) to the extent that the dividend is payable at a fixed rate. IRC § 2701(c)(3). A cumulative distribution payable at least annually at a fixed rate or amount is a qualified payment. Treas. Reg. § 25.2701-2(b)(6). If the distribution is made up to four years following its due date, it is treated as having been made on time. *Id.* If the payment is made after the four-year grace period, it must essentially accrue interest at the discount rate in effect at the time the transfer was made. Treas. Reg. § 25.2701-4(c)(3). The senior family member should avoid retaining any "extraordinary payment rights," such as puts, calls, conversion rights, or the right to compel liquidation, the exercise or nonexercise of which affects the value of the transferred interest. Treas. Reg. § 25.2701-1(a)(2)(i).67

2. **Structuring the Preferred Payment Rights.** In most cases, the preferred partnership interest will be structured with a cumulative annual preferential right to partnership cash flow. The right may be stated as a fixed dollar amount, or, mirroring preferred stock, as a fixed percentage of a fixed liquidation preference amount (for example, 7% of a $5 million liquidation preference). If the preferred payment right goes into arrears for more than four years, the unpaid payments bear interest at an appropriate rate. IRC §§ 2701(d)(2)(A)(i), (d)(2)(C). The partnership agreement often permits the general partners to make the preferred payment in kind if partnership cash is insufficient. Upon liquidation of the partnership, the preferred interest receives a stated amount ($5 million in the above example) before any other partners receive distributions. Again, the liquidation payment may be in cash or in kind. The partnership agreement

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may give the partnership the right to call the preferred interest upon the death of the preferred holder by paying all accrued unpaid distributions plus the preferred liquidation payment.

3. **Valuing the Preferred Interest.** Commentators and the IRS assert that the standard for valuing a qualified preferred interest is Revenue Ruling 83-120, 1983-2 CB 170, which deals with the valuation of preferred stock. That ruling provides that valuation is based upon (i) yield; (ii) preferred payment coverage; and (iii) protection of the liquidation preference. The ruling states that the yield is to be compared against the dividend yield of high-grade, publicly traded preferred stock. It goes on to provide that publicly traded preferred stock for a company having a similar business and similar assets with similar liquidation preferences, voting rights and other similar terms would be the ideal comparable for determining the yield required in arm's length transactions for closely held stock. If the partnership cannot borrow from an independent lender at the same rate they lend to their most credit-worthy borrowers, the yield on the preferred interest should be correspondingly higher. "Coverage" is measured by the ratio of the sum of earnings to the sum of the total interest to be paid and the earnings needed to pay the dividend. Protection of the liquidation preference is determined by comparing the amount of the preference to the value of the partnership's total assets. In short, the preferred partnership interest should be valued very near the amount of its liquidation preference if (i) the yield is comparable to preferred stock yields in publicly traded securities; (ii) the partnership produces enough earnings to pay that yield; and (iii) the partnership is likely to have sufficient assets to pay the liquidation preference if the partnership is liquidated. Naturally, estate planners can design the partnership's terms to control the amount of the preferred payment and the liquidation preference. The yield on high-grade publicly traded preferred stock, on the other hand, is driven by market forces. When market yields for publicly traded preferred stocks are high, the preferred partnership interest requires a corresponding high payment preference. When yields are lower, the partnership can be structured with a lower preference.

4. **Giving Away the Preferred Partnership Interest.** Remember that the special valuation rules do not apply if the transferor gives away the preferred partnership interest and keeps the common interest. A preferred payment right with, for example, a 7% guaranteed return, could presumably be given to a GRAT or a CLAT when the Section 7520 rate is significantly lower than the preferred payment rate (the Section 7520 rate is 2.2% in July, 2017. So long as the partnership is able to make its payments at the stated rate, when the trust terminates, the remainder beneficiaries are certain to receive the arbitrage between the guaranteed rate and the Section 7520 rate in effect when the trust was formed. For example, under current interest rates, a gift of a 7% guaranteed payment partnership interest would ensure a wealth transfer of 4.4% annually (the 7% payment rate minus the 2.6% Section 7520 rate).

5. **Giving Away the Common Partnership Interest.** If the preferred partnership interest is structured with a "qualified payment," then the interest will not be valued at zero for purposes of Section 2701. IRC § 2701(a)(3). As a result, if the transferor retains that interest while giving away the common partnership interest, the common interest can be valued by subtracting the value of the preferred interest from the value of all of the interests held by the transferor prior to the transfer. In other words, in addition to potential discounts for lack of control and lack of marketability, an additional discount may be taken for the value of the preferred interest retained by the transferor. See Treas. Reg. § 25.2512-5(d)(2).

6. **Where to Give.** As discussed above, gifts and sales to IDGTs work best when the asset transferred has a high potential for growth. If the preferred partnership interest is structured with a "qualified payment," and if the return inside the partnership (considering both growth and income) exceed the preferred payment rate, then the common interest would be very well suited as an asset to transfer to an IDGT, especially if partnership cash flow (after paying the preferred return) is still sufficient to service the debt payable to the donor. If most partnership cash flow will be used to make the payment to the preferred interest holders, then an outright gift of the common interest into a trust or IDGT might be a better strategy, since in that event, the holder of the common interest would not need cash flow to service the debt. As noted above, gifts of the preferred interest to a GRAT or CLAT may enable the donor to move the amount of the preferred payment in excess of the Section 7520 rate at the time of the gift out of the estate with minimal gift tax exposure.
VII. IRC § 2704 AND THE PROPOSED REGULATIONS

It was rumored for years that Treasury planned to exercise its authority to issue regulations under Code Section 2704 to limit (or possibly eliminate?) discounts that apply when certain assets are transferred between certain family members. On August 4, 2016, the IRS and Treasury released proposed Treasury Regulations regarding Code Section 2704, which both amend existing regulations and add one new regulation. See Estate, Gift, and Generation-Skipping Transfer Taxes: Restrictions on Liquidation of an Interest, 81 Fed. Reg. 51,413 (Aug. 4, 2016). When issuing the regulations, the IRS and Treasury invited comments. A huge number of commentators—over 9,800—took them up on this invitation, including The American College of Trust and Estate Counsel ("ACTEC"), the American Institute of Certified Public Accountants, trade groups, valuation professionals, and business owners. A hearing was held on the proposed regulations on December 1, 2016. The regulations can become final any time, although as have most incoming administrations, the current President has put on hold all pending regulatory issuances until they can be reviewed by the relevant cabinet officials.

A. IRC Chapter 14 – Special Valuation Rules

Chapter 14 of the Code, which is comprised of Sections 2701-2704, provides special valuation rules that are applied in the case of certain estate planning techniques. In the case of transfers of an interest in a family-controlled corporation, partnership, or other business entity to a family member, the provisions of Sections 2701, 2703, and 2704 are of special concern and their application to the transfer may result in adverse gift and/or estate tax consequences, due to the loss of discounts that would otherwise apply when valuing an interest in the entity.

Section 2701 is aimed at traditional business entity transfers to a family member of the transferor that seek to "freeze" the value of the transferred interest while passing future appreciation of the value of the interest to the transferee. Section 2703 causes restrictions placed on the interest, or agreements such as buy-sell agreements or those to purchase property for less than fair market value, to be disregarded for valuation purposes, if those restrictions fail to meet certain criteria. Section 2704 applies in two scenarios by causing (a) a lapse of a voting or liquidation right to be treated as a taxable transfer, and (b) applicable restrictions involving limits on the right to liquidate the entity to be disregarded when valuing an interest in an entity. The proposed regulations issued on August 4, 2016 focus on Section 2704, so the focus of the following discussion will be on that section.

1. Section 2704. Section 2704 was enacted in an attempt to overturn the Tax Court's decision in Estate of Harrison v. Commissioner, 1987-8. The significant factors of Section 2704(a) are that a voting or liquidation right must lapse, the individual with the lapsing right and members of the individual's family must have control of the entity before and after the lapse, and there must be a difference in value of the interest held by the individual before and after the lapse. If these factors exist, Section 2704(a) treats the lapse as a taxable transfer which will either be a gift or a transfer includible in the individual's estate, and the amount of the transfer will be equal to the excess of the value of all interest held by the individual before the lapse less the value of those interests immediately after the lapse.

Section 2704(b) provides that if a transferor and members of the transferor's family control an entity before a transfer and a transfer is made to a member of the transferor's family, any applicable restriction (discussed in more detail below) is disregarded in valuing the transferred interest. One important exception to what constitutes an applicable restriction is that if the restriction is one that is imposed or required to be imposed under federal or state law, it is not considered an applicable restriction. IRC § 2704(b)(3).

68 Section 2704(c)(2) provides that the term "member of the family" means, with respect to any individual, (A) such individual's spouse, (B) any ancestor or lineal descendant of such individual or such individual's spouse, (C) any brother or sister of the individual, and (D) any spouse of any individual described in (B) or (C).

69 81 Fed. Reg. 51,413, 51,414 (Aug. 4, 2016) (Background Information); see also Estate of Harrison v. Commissioner, TC Memo 1987-8. In Estate of Harrison, the Tax Court held that the value of an interest in a family-controlled limited partnership held at death did not include the decedent’s right to compel liquidation of the partnership which lapsed upon the decedent’s death. The lapse of this right resulted in a discounted value of the decedent’s partnership interest for federal estate tax purposes.
In issuing the proposed regulations, the Preamble to the proposed regulations cite Code Section 2704(b)(4) as giving the Secretary the authority to "provide that other restrictions shall be disregarded in determining the value of any interest in a corporation or a partnership transferred to a member of the transferor's family if the restriction has the effect of reducing the value of the transferred interest for transfer tax purposes but does not ultimately reduce the value of the interest to the transferee." Each of the proposed regulations makes it clear that they apply for estate, gift, and GST tax purposes. Prop. Treas. Reg. §§ 25.2704-1(a)(i), -2(a), -3(a). Thus, not only do the proposed regulations apply to transfers of interests that occur during life, but if an owner of a family-controlled entity dies, the proposed regulations apply to all interests owned at death.

2. **Amending Grandfathered Restrictions.** Chapter 14 was enacted in 1990. See P.L. 101-508, § 11602, 104 Stat. 1388, 1388-491 to 1388-501 (1990). For Section 2704, the effective date specifies that it applies to restrictions or rights (or limitations on rights) created after October 8, 1990. P.L. 101-508, § 11602(e)(1)(A)(iii), 104 Stat. 1388, 1388-500 (1990). Therefore, it is important to keep in mind (like we do with grandfathered GST-exempt trusts) that we should use caution if, and consider not, amending any restriction or right that was in place on that date.

B. **Disregarded Restrictions—Prop. Treas. Reg. § 25.2704-3**

1. **Definition of a "Disregarded Restriction."** The proposed Treasury Regulations introduce a new class of restrictions termed "disregarded restrictions" that relate to the ability of a transferor or a member of the transferor's family to redeem or liquidate an interest in the entity. If an interest in a family-controlled entity is transferred between family members and that interest has any restriction on the ability to liquidate or redeem the interest, and if the restriction lapses upon the transfer of the interest or can be removed by the transferor, the transferor's estate, or a member of the transferor's family, the restriction is treated as if it doesn't exist and the restriction is disregarded when valuing the interest for estate, gift, and GST tax purposes. Prop. Treas. Reg. §§ 25.2704-3(b)(1), (b)(3). In addition to considering interests held directly, these rules apply if an interest is held indirectly. Prop. Treas. Reg. § 25.2704-3(b)(3). For determining whether an interest is held indirectly, the attribution rules of Treasury Regulation Section 25.2701-6 apply. However, in determining who is a member of the family, the rules of Treasury Regulation Section 25.2702-2(a)(1) apply. Prop. Treas. Reg. § 25.2704-3(d). Pursuant to that section, a member of the family includes an individual's spouse, an ancestor or lineal descendant of either the individual or the individual's spouse, a brother or sister of the individual, or a spouse of any of them. Restrictions on the ability to redeem or liquidate an interest may be disregarded whether they are imposed pursuant to virtually any document, agreement, or arrangement related to the entity or a transfer of an interest in the entity, or if the restriction is imposed under local law. Prop. Treas. Reg. § 25.2704-3(b)(2).

2. **Safe Harbors.** Another way of thinking of the application of these rules is that if an interest in a family-controlled business is transferred to a family member, and if that interest has some restriction or limitation on the ability of the transferor, the transferor's estate, or a member of the transferor's family to redeem or liquidate the interest, then for valuation purposes, the restriction must at a minimum meet (or not be less restrictive than) several safe harbors. Unfortunately, the requirements necessary to satisfy these safe harbors are drawn so narrowly that they are virtually impossible to meet. Specifically:

(i) the holder of the interest must be able to compel liquidation or redemption of the interest;

(ii) for an amount equal to at least a Minimum Value;

(iii) the payment of which cannot be deferred for more than six months after the date the holder gives notice of the intent to have the interest liquidated or redeemed; and

(iv) the payment of which must be paid in cash, with property, or for a Qualified Note.


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70 Prior to proposed Treasury Regulation Section 25.2704-3, the liquidation right addressed in the regulations under Section 2704 was only the right to liquidate the entity itself. See Treas. Reg. § 25.2704-1.
If a restriction violates any one of these safe harbors, the restriction is ignored or "disregarded" and the fair market value of the transferred interest is determined under "generally applicable valuation principles." Prop. Treas. Reg. § 25.2704-3(f). Note that the reverse is not true. If a restriction violates the safe harbors, the safe-harbor rules are not read into the entity's governing documents. Instead, the restriction is simply ignored for valuation purposes. Contrary to the concerns expressed by many commentators, no "deemed" put right is read into the arrangement.

a. Minimum Value. The safe harbors for restrictions use a number of technical terms. Regrettably, the drafters made some unfortunate and confusing choices for these terms. For example, the "Minimum Value" that the interest holder must receive for the interest under the safe harbor is an amount equal to the interest's percentage share of the net value of the entity on the date of liquidation or redemption. Prop. Treas. Reg. § 25.2704-3(b)(1)(ii). The net value, which is essentially the liquidation value of the entity, equates to the fair market value of the property held by the entity as determined for federal estate or gift tax purposes, less any outstanding obligations that would be allowable as debts for federal estate tax purposes under Code Section 2053. Id. If property held by the entity includes an interest in another entity that would be subject to Code Section 2704 if a transfer of an interest in that entity was made, then the entity will be treated as owning a share of the property held by the other entity and the same valuation rules are applied. Id. Many commentators on the proposed regulations naturally assumed that "minimum value" somehow ascribed an actual minimum value for a transferred interest, but a careful reading of the regulations shows that it does not. Treasury officials have confirmed that they had no such intention. Rather, "minimum value" is a construct used for the limited purpose of testing whether a given restriction is to be disregarded (and, as discussed below, whether interests held by non-family members are to be considered).

b. Qualified Note. The safe harbor rules specify that if payment of the liquidation or redemption proceeds is made by a promissory note that is not a "Qualified Note," the note is not deemed to be property. Prop. Treas. Reg. § 25.2704-3(b)(1)(iv). In order to allow payment of the liquidation or redemption proceeds by a Qualified Note, the note must be issued by a person unrelated to the entity, the owners of the entity, or persons related to either the entity or the owners, unless the entity meets certain qualifications as an active trade or business. Specifically, if the entity is engaged in an active trade or business and at least 60 percent of the value of the business consists of the non-passive assets of that trade or business, a note may be used in payment of the portion of the interest attributable to the active trade or business, as long as the note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. Id. For a person to be unrelated for purposes of issuing a note, the somewhat complex attribution rules of IRC § 267(b) are applied, although one exception is made in that the term fiduciary of a trust does not include a federally or state chartered bank, trust company, or savings and loan that is publicly held. Id.

c. Nonfamily Members. Certain nonfamily member interests are to be taken into account with the possibility of overcoming the disregarded restriction limitation for valuation purposes. Conversely, in determining whether the transferor, the transferor's estate, or any member of the transferor's family may remove a restriction and thereby potentially have such restriction disregarded, interests held by anyone other than nonfamily members who meet certain criteria are disregarded. If a nonfamily member interest is disregarded, for purposes of proposed Treasury Regulation Section 25.2701-3, it is treated as if it does not exist. Prop. Treas. Reg. § 25.2704-3(b)(4)(ii). For this purpose, the proposed regulations introduce the first of two new three-year rules in the transfer tax area.

Specifically, the only nonfamily member interests that are to be taken into account are those held by a Gryphon71. A Gryphon is someone other than a member of the transferor's family who holds an interest in the entity that on the date of the transfer:

71 Gryphons are mythical creatures which have an amalgamation of well understood features (the head, talons, and wings of an eagle and the body of a lion) that make visualizing them easy, but whose features, each of which actually exist in nature, never co-exist in real life. No, you won’t find the term “Gryphon” in the proposed Treasury Regulations, but it does help to illustrate the concept.
(A) has been held for at least three years immediately before the transfer;

(B) constitutes at least 10 percent of the value of the entity, being at least 10 percent of all of the equity interests if the entity is a corporation, or at least a 10-percent interest in any other business entity (such as at least a 10-percent interest in the capital and profits of a partnership);

(C) when combined with interests held by all other nonfamily members constitutes at least 20 percent of the value of all of the equity interests if the entity is a corporation, or at least 20 percent of all the interests in any other business entity (such as at least a 20-percent interest in the capital and profits of a partnership); and

(D) has a Put Right.


d. **Put Right.** A "Put Right" means an enforceable right of an interest holder on liquidation or redemption of the holder's interest to receive within six months after the date the holder gives notice of the holder's intent to withdraw, cash, property or a Qualified Note from the entity or from one or more other interest holders, with a value that is at least equal to the Minimum Value of the interest as of the liquidation or redemption date. Prop. Treas. Reg. § 25.2704-3(b)(6).

3. **Additional Exceptions.** Proposed Treasury Regulation Section 25.2704-3(b)(5) provides some additional exceptions to what will be a disregarded restriction. Specifically, a restriction will not be disregarded if:

(i) it is an applicable restriction on the liquidation of the entity as described in Treasury Regulation Section 25.2704-2, as further discussed below;

(ii) it is a "commercially reasonable restriction" on liquidation imposed by an investor or lender who is not related to the transferor, the transferee, or any member of their families pursuant to the related party rules of Code Section 267(b), (but a fiduciary of a trust does not include a federally or state chartered bank, trust company or savings and loan that is publicly held);

(iii) it is a restriction imposed or required to be imposed by federal or state law, but for this purpose, you must ignore (A) a provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded by anyone or in any way; (B) a law that is limited to narrow classes of entities, especially entities (such as family-controlled entities) most likely to be subject to transfers described in Code Section 2704; and (C) a law that has an optional provision that does not include the restriction, that allows the restriction to be removed or overridden, or that provides a different statute for the creation and governance of the same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded;

(iv) it is an option, right to use property, or agreement that is subject to Code Section 2703, because those rights are deemed to not be restrictions; or

(v) every holder of an interest in the entity has a Put Right.


1. **Definition of an "Applicable Restriction."** Certain limitations on the ability to liquidate the entity itself, termed "applicable restrictions," are also disregarded when valuing an interest for gift, estate, and GST tax purposes. Section 2704(b) provides that if an interest is transferred to or for the benefit of a member of the transferor's family and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any applicable restriction is disregarded when valuing the interest. Therefore, for valuation purposes, it is as if the restriction doesn't exist. An applicable restriction is (i) a limitation on the ability to liquidate all or part of an entity, (ii) if after a transfer of an interest, the limitation lapses or may be removed by the transferor, the transferor's estate, and/or any member of the transferor's family. IRC § 2704(b).

2. **Exceptions to Applicable Restrictions.** Section 2704(b)(3) provides that an applicable restriction does not include a commercially reasonable restriction made part of a financing agreement with
an unrelated person, or a restriction required under federal or state law. The element that sets Section 2704(b) apart from Section 2704(a) is this reference to state law. As mentioned above, if a restriction is imposed or required to be imposed by state law, it is not an applicable restriction. The current regulations further expanded this exception by providing that applicable restrictions are only those limitations that are more restrictive than the default limitations provided by state law. Treas. Reg. § 25.2702-2(b). However, unlike the current regulations, the proposed regulations narrow the exception as it relates to state law. The proposed regulations delete this "more restrictive" limitation, and as with a disregarded restriction, provide that an applicable restriction may be disregarded whether it is a restriction provided for in virtually any document, agreement, or arrangement related to the entity or a transfer of an interest in the entity, or if the restriction is imposed under local law "regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise." Prop. Treas. Reg. § 25.2704-2(b)(2). The proposed regulations further restrict what is considered "imposed by state law." Proposed Treasury Regulation Section 25.2702-2(b)(4)(ii) provides that if the governing instrument can include provisions different than state law, if anyone can override a statutory provision, or if a provision that provides restrictions is optional under state law, the restriction is still an applicable restriction. Essentially, under the proposed regulations, unless state law mandates the restriction and there is no way that the restriction can be waived or ignored in any way, it will be an applicable restriction and will be disregarded for valuation purposes.

3. **Rules that Apply to Both Disregarded and Applicable Restrictions.** The proposed regulations equate "applicable" and "disregarded" restrictions in a number of ways. For example, as with a disregarded restriction, in addition to holding an interest in an entity directly, in determining whether an interest is held indirectly, the attribution rules of Treasury Regulation Section 25.2701-6 apply. Prop. Treas. Reg. § 25.2704-2(d). Also as with a disregarded restriction, the additional exceptions listed above apply so that a restriction will not be considered an applicable restriction if it is a commercially reasonable restriction, a restriction required by federal or state law, an agreement subject to Code Section 2703, or every owner has a Put Right. Prop. Treas. Reg. § 25.2704-3(b)(4). In addition, similar to the safe harbors for disregarded restrictions, if an applicable restriction does not fall within the exceptions, the restriction is then ignored for valuation purposes, but no liquidation right is imputed to anyone. The applicable restriction regulations apply the same controlled entity definition found in Treasury Regulation Section 25.2701-2(b)(5), and the same rule that if an applicable restriction is disregarded, the fair market value of a transferred interest is determined under generally applicable valuation principles as if the restriction doesn't exist. Prop. Treas. Reg. §§ 25.2704-3(c), (d), (e). Exhibit G provides a decision tree to illustrate the thought process to be made as to whether any particular restriction is to be ignored when valuing a transfer, whether by gift or at death, of an interest in an entity.

D. **Lapses of Voting or Liquidation Rights—Prop. Treas. Reg. § 25.2704-1**

1. **Voting and Liquidation Rights.** Certain lapses of voting or liquidation rights associated with an interest in a family-controlled business entity will be treated as a transfer of that interest for gift, estate and GST tax purposes. A voting right is the right to vote with respect to any matter of the entity and includes a right to participate in management of the entity. Prop. Treas. Reg. § 25.2704-1(a)(2)(iii). A limited liability company member's right to participate in management is deemed a voting right. Id. A liquidation right is the right or ability of an equity interest holder to compel the entity to acquire all or any portion of the interest. Prop. Treas. Reg. § 25.2704-1(a)(2)(iv) (note that only the numbering of this section changed; the language is unchanged from the current regulation). With each of these rights, the lapse occurs when a presently exercisable right is restricted or eliminated. Treas. Reg. § 25.2702-1(c)(1).

2. **Treatment of a Lapse.** If a voting or liquidation right in a family-controlled corporation, partnership, or other business entity lapses, the lapse will be treated as a transfer of the interest itself by the individual holding the right directly or indirectly, with a few exceptions as noted below. Prop. Treas. Reg. § 25.2704-1(a)(1). For the lapse to be treated as a transfer, the transferor and/or members of the transferor's family must control the entity before and after the lapse. Id. The value of any deemed transfer is equal to the excess, if any, of the value of all of the holder's interests in the entity immediately before the lapse over the value of the interests immediately after the lapse (determined as if all such interests were held by one individual). Treas. Reg. § 25.2704-1(d).
3. **Restriction or Elimination of Rights and the Three-Year Rule.** The regulations already provide that if a transfer of an interest results in the lapse of a liquidation right but the rights associated with the transferred interest are not restricted or eliminated, the lapse is not subject to Section 2704. Treas. Reg. § 25.2704-1(c)(1). The theory is that the liquidation rights are not restricted or eliminated because they are transferred along with the interest, which means their value is also transferred. However, the proposed regulations now tweak this rule by adopting another three-year rule. Specifically, the proposed regulations provide that in order for this exception to apply to either liquidation or voting rights, the transfer must occur more than three years before the transferor's death. If the transferor's death occurs within three years of the transfer, the lapse is treated as occurring on the transferor's date of death, resulting in a transfer includible in the transferor's gross estate under Code Section 2704(a). Prop. Treas. Reg. § 25.2704-1(c)(1). It is important to note that the effective date for the proposed regulations does not address whether this deemed transfer-at-death rule applies if a transfer is made before the proposed regulations are final and then death occurs within three years of the transfer. Treasury personnel have indicated that the effective date provisions were intended to apply only to actual and not deemed transfers. It is expected that the final regulations will clarify this issue.

4. **Requirement of Ability to Liquidate After Lapse.** The regulations also provide that Section 2704(a) will not apply if the interest holder, interest holder's estate, or a member of the holder's family cannot liquidate the interest immediately after a lapse, if the interest could have been liquidated immediately before the lapse. Treas. Reg. § 25.2704-1(c)(2)(i)(A). Whether an interest can be liquidated immediately after a lapse is determined under local law, as modified by the governing documents of the entity, but without regard to any applicable restriction or disregarded restriction. Prop. Treas. Reg. § 25.2704-1(c)(2)(i)(B). As with applicable and disregarded restrictions, however, any interest held by a person other than a "Gryphon" is disregarded. Id.

5. **Assignee Interests.** Another new addition in the proposed regulations is the treatment of an assignment of an interest in an entity. Proposed Treasury Regulation Section 25.2704-1(a)(5) now provides that if a transfer results in the restriction or elimination of the transferee's ability to exercise voting or liquidation rights that the transferor had, a lapse occurs for purposes of Section 2704. To illustrate the point, the proposed regulations use an assignment of an interest where the assignee has no voting or liquidation rights as an example. Prop. Treas. Reg. § 25.2704-1(a)(5).

6. **Features in Common with Ignored Restrictions.** The lapsing-rights regulations apply a number of terms in common with the ignored restriction regulations. For example, they apply the same definition of member of the family as the applicable restriction regulations. Prop. Treas. Reg. § 25.2704-1(a)(ii). In addition, in determining whether an interest is held indirectly, the attribution rules of Treasury Regulation Section 25.2701-6 apply. Prop. Treas. Reg. § 25.2704-1(a)(2)(i). The lapsing-rights regulations also apply the same controlled entity definition found in Treasury Regulation Section 25.2701-2(b)(5). Id.

E. **Other Definitions**

1. **"Controlled Entity."** The IRS and Treasury have chosen to take the opportunity with these proposed regulations to expand the definition of a "controlled entity." Prop. Treas. Reg. § 25.2701-2(b)(5). Whereas under the current regulations, the definition is limited to a corporation or partnership, and there is some question as to whether state law or federal tax law is applied to determine the type of the entity, by referencing Treasury Regulation Section 301.7701-2(a), proposed Treasury Regulation Section 25.2701-2(b)(5) clarifies that a "controlled entity" includes three types of entities, namely a corporation, partnership, or "any other entity or arrangement that is a business entity," which is controlled.

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72 Note, however, that the regulations continue to provide that notwithstanding this exception, a transfer that results in the elimination of the transferor's right or ability to compel the entity to acquire an interest retained by the transferor that is subordinate to the transferred interest is a lapse of a liquidation right with respect to the subordinate interest.

73 Treasury Regulation Section 301.7701-2(a) includes single-member disregarded entities in the definition of a business entity. Presumably, entities disregarded because they are owned by a husband and wife in a community property state would be included as well.
immediately before a transfer, by the transferor, applicable family members\textsuperscript{74}, and/or any lineal descendants of the parents of the transferor or the transferor’s spouse. Prop. Treas. Reg. § 25.2701-2(b)(5)(i). For any entity not classified as a corporation, the law where the entity is created determines the form of the entity, and classification for federal tax purposes, including whether the entity is a disregarded entity, is irrelevant. \textit{Id}. These changes to the regulations clarify that a limited liability company will be treated as a business entity.

In addition to clarifying the types of entity to which Code Section 2704 applies, the proposed regulations clarify that the form of the entity determines the applicable test for control. Prop. Treas. Reg. § 25.2701-2(b)(5)(i). For a corporation, control means holding at least 50 percent of the voting rights or fair market value of the equity interests in the corporation. Treas. Reg. § 25.2701-2(b)(5)(ii)(A). Equity interests that only have a right to vote regarding liquidation, merger, or a similar event are not considered to have voting rights. Treas. Reg. § 25.2701-2(b)(5)(ii)(B). If an equity interest with voting rights is held in a fiduciary capacity, the voting rights are deemed to be held by each beneficial owner of the interest and by each individual who is a permissible recipient of the income from the interest. \textit{Id}. For any partnership, control means holding at least 50 percent of the capital or profits interest in the partnership. Treas. Reg. § 25.2701-2(b)(5)(iii). In addition, in the case of a limited partnership, control means the holding of any equity interest as a general partner. \textit{Id}. For entities or arrangements other than a corporation or partnership, control means holding at least 50 percent of either the capital or profits interests, or an equity interest with the ability to cause the liquidation of the entity or arrangement in whole or in part. Prop. Treas. Reg. § 25.2701-2(b)(5)(iv).

2. \textbf{Indirect Ownership}. An individual, the individual's estate, and members of the individual's family are treated as also holding any interest held indirectly through a corporation, partnership, trust, or other entity under the rules contained in Treasury Regulation Section 25.2701-6. Thus, an individual is treated as holding an equity interest to the extent it is held indirectly through a corporation, partnership, estate, trust, or other entity. If an equity interest is treated as held by someone in more than one capacity, the interest is treated as held by that person in the way that attributes the largest total ownership of the equity interest. Treas. Reg. § 25.2701-6(a)(1). An equity interest held by a lower-tier entity is attributed to higher-tier entities so that, for example, if an individual is a 50-percent beneficiary of a trust that holds 50 percent of the preferred stock of a corporation, 25 percent of the preferred stock is considered held by the individual.

F. \textbf{Effective Dates for Final Regulations}

The proposed regulations provide two effective dates. For the proposed regulations, other than those that address disregarded restrictions in Treasury Regulation Section 25.2704-3, the effective date is when they are published as final regulation in the Federal Register. Prop. Treas. Reg. § 25.2704-4(b)(1), (2). The proposed regulations that address disregarded restrictions are effective 30 days after they are published as final regulations. Prop. Treas. Reg. § 25.2704-4(b)(3). As noted above, the proposed regulations apply only to restrictions or rights (or limitations on rights) created after October 8, 1990. Restrictions or rights in effect on or before that date should be changed or eliminated only after considering the impact these regulations may have on such change or elimination.

G. \textbf{Adequate Disclosure Rules}

Although these are proposed regulations, when reporting a transfer that may be implicated by the provisions, the adequate disclosure rules of Treasury Regulation Section 301.6501(c)-1 should be considered and addressed, as appropriate. The adequate disclosure rules provide that for certain gifts made

\textsuperscript{74} Note that IRC § 2701 contains two definitions of “applicable family member.” Although IRC § 2701(e)(2) defines the term to include the transferor’s spouse, an ancestor of the transferor or transferor’s spouse, and the spouse of an ancestor, for determining control, IRC § 2701(b)(2)(C) defines the term to also include any lineal descendant of any parent of the transferor or the transferor’s spouse. Therefore, for purposes of control, all ancestors and spouses of ancestors of the transferor and transferor’s spouse as well as nieces and nephews are included, but aunts, uncles, and spouses of any generation \textit{the same} or below the transferor or transferor’s spouse (which would include spouses of children of each or both of them) are not included.
after December 31, 1996, if the transfer is not adequately disclosed on a gift tax return, the statute of limitations for assessment of tax on the transfer will not begin to run unless certain safe harbors are met. Treas. Reg. § 301.6501(c)-1(f). One of those safe harbors provides that a statement must be made on a return or a statement attached thereto as to "any position taken that is contrary to any proposed . . . Treasury regulations . . . published at the time of the transfer." Treas. Reg. § 301.6501(c)-1(f)(2)(v).

H. Illustration

D owns 100% of company. He sells 20% to X, a third party, and somehow X extracts a Put Right, payable in cash or property within 6 months of notification of exercise. The documents and state law specify a 2/3 vote is required to liquidate the company, and modification of the entity agreements requires unanimous approval by the owners. More than three years after the sale, when X is thus a "Gryphon" (and after the Section 2704 regulations become final), D gives 20% of the company to each of his two children, A and B. When valuing each gift of a 20% interest to A and B, there will be discounts for lack of control. The fact that neither A nor B can force a liquidation of their interest is not ignored, because the participation of X is required to remove the restriction, and X is a "Gryphon" (i.e., a ≥10%, ≥20%, ≥3 yr-owner-with-a-put), and thus not an ignored third party per proposed Treasury Regulation Section 25.2704-3(b)(4). But for the interest held by X, however, the inability to liquidate would be ignored and gifts would be valued based upon "generally applicable valuation principles." The nature of the underlying assets of the entity may greatly affect these principles.

When D makes a gift to A and B, we also start a three year clock ticking, because before the gifts, D, holding 80%, could unilaterally vote to liquidate the company. After the gift, D holds only 40%, so his unilateral right to liquidate the company has lapsed. If D lives for three years, we don't care, but if D dies within three years, then there is a lapse which is treated as occurring at D's death under proposed Treasury Regulation Section 25.2504-1(c)(1). See also proposed Treasury Regulation Section 25.2704-1(f), Ex. 4. Under Treasury Regulation Section 25.2704-1(d), the amount of the transfer is the value of D's interest immediately before the lapse over the value to the interest after the lapse. In other words, in valuing the 40% block of stock that D retained for estate tax purposes, we (i) include the value of the 40%, presumably without liquidation rights, since that is what he owned at death; and (ii) we also include under proposed Treasury Regulation Section 25.2704-1(d) a phantom value which is equal to the difference between the value that D's 80% would be worth at D's death if D still held the unilateral right to liquidate D's interest in the entity, and the value of that interest immediately after the lapse.

This transaction is thus is comparable to a gift by D of a life insurance policy, where a gift itself arises on the change of ownership (measured by the value of the contract or interpolated terminal reserve values). But there may be additional estate tax inclusion of a phantom value (death benefit) if D dies within 3 years of the gift of the life insurance. Likewise, the transfer of 20% of the company to A and B is a gift. But there may be additional estate tax inclusion of a phantom value (measured by the loss in value attributable to the lapsed liquidation right), if D dies within three years of the transfer to A and B.

VIII. CONCLUSION

Estate planning continues to evolve. In working with clients to achieve their estate planning goals and objectives, planners need to be aware of the tools and techniques that have been used for years, but also need to be mindful of how those techniques can be adapted to take into account today's high (inflation adjusted) estate tax exemptions and an increased focus on income taxes, not to mention how these techniques may be affected by the recent proposed 2704 regulations. Add in portability and a new emphasis on obtaining basis adjustments, clients may expect their planning to be more "simple." It's up to us to guide them through the twists and turns of today's estate planning environment!
### EXHIBIT A

#### Historical Estate, Gift, and GST Tax Exemption Amounts and Top Tax Rates (1916-2017)

<table>
<thead>
<tr>
<th>Year</th>
<th>Estate Tax Exemption</th>
<th>Gift Tax Exemption</th>
<th>Gift Tax Annual Exclusion</th>
<th>GST Tax Exemption</th>
<th>Top Estate (and GST) Tax Rate</th>
<th>Top Gift Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1916</td>
<td>$50,000</td>
<td>No Gift Tax</td>
<td>None</td>
<td>No GST Tax</td>
<td>10%</td>
<td>0%</td>
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<tr>
<td>1917-23</td>
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<td>1924-25</td>
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<td>$50,000</td>
<td>$500</td>
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<td>25%</td>
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<td>None</td>
<td>No GST Tax</td>
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<td>0%</td>
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<tr>
<td>1932-33</td>
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<td>No GST Tax</td>
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<td>34%</td>
</tr>
<tr>
<td>1934</td>
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<td>$50,000</td>
<td>$5,000</td>
<td>No GST Tax</td>
<td>60%</td>
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</tr>
<tr>
<td>1935-37</td>
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<td>$40,000</td>
<td>$5,000</td>
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<td>53%</td>
</tr>
<tr>
<td>1938-40</td>
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<td>$40,000</td>
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</tr>
<tr>
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</tr>
<tr>
<td>1942-76</td>
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<td>77%</td>
<td>58%</td>
</tr>
<tr>
<td>1977²</td>
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<td>$120,000</td>
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<td>1st GST Tax³</td>
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</tr>
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</tr>
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<tr>
<td>1981</td>
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<td>1st GST Tax</td>
<td>70%</td>
<td>70%</td>
</tr>
<tr>
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<td>1st GST Tax</td>
<td>65%</td>
<td>65%</td>
</tr>
<tr>
<td>1983</td>
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<td>$10,000</td>
<td>1st GST Tax</td>
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<td>60%</td>
</tr>
<tr>
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<td>$10,000</td>
<td>1st GST Tax</td>
<td>55%</td>
<td>55%</td>
</tr>
<tr>
<td>1985</td>
<td>$400,000</td>
<td>$400,000</td>
<td>$10,000</td>
<td>1st GST Tax</td>
<td>55%</td>
<td>55%</td>
</tr>
<tr>
<td>1986</td>
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<td>$500,000</td>
<td>$10,000</td>
<td>1st GST Tax</td>
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<td>55%</td>
</tr>
<tr>
<td>1987-97</td>
<td>$600,000</td>
<td>$600,000</td>
<td>$10,000</td>
<td>$1,000,000</td>
<td>55%</td>
<td>55%</td>
</tr>
<tr>
<td>1998</td>
<td>$625,000</td>
<td>$625,000</td>
<td>$10,000</td>
<td>$1,000,000</td>
<td>55%</td>
<td>55%</td>
</tr>
<tr>
<td>1999</td>
<td>$650,000</td>
<td>$650,000</td>
<td>$10,000</td>
<td>$1,000,000</td>
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<td>2001</td>
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<td>$675,000</td>
<td>$10,000</td>
<td>$1,000,000</td>
<td>55%</td>
<td>55%</td>
</tr>
<tr>
<td>2002</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$11,000</td>
<td>$1,000,000</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>2003</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$11,000</td>
<td>$1,000,000</td>
<td>49%</td>
<td>49%</td>
</tr>
<tr>
<td>2004</td>
<td>$1,500,000</td>
<td>$1,000,000</td>
<td>$11,000</td>
<td>$1,500,000</td>
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<td>$1,000,000</td>
<td>$11,000</td>
<td>$1,500,000</td>
<td>47%</td>
<td>47%</td>
</tr>
<tr>
<td>2006</td>
<td>$2,000,000</td>
<td>$1,000,000</td>
<td>$12,000</td>
<td>$2,000,000</td>
<td>46%</td>
<td>46%</td>
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<tr>
<td>2007</td>
<td>$2,000,000</td>
<td>$1,000,000</td>
<td>$12,000</td>
<td>$2,000,000</td>
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<td>45%</td>
</tr>
<tr>
<td>2008</td>
<td>$2,000,000</td>
<td>$1,000,000</td>
<td>$12,000</td>
<td>$2,000,000</td>
<td>45%</td>
<td>45%</td>
</tr>
<tr>
<td>2009</td>
<td>$3,500,000</td>
<td>$1,000,000</td>
<td>$13,000</td>
<td>$3,500,000</td>
<td>45%</td>
<td>45%</td>
</tr>
<tr>
<td>2010</td>
<td>$5,000,000³</td>
<td>$1,000,000</td>
<td>$13,000</td>
<td>GST Tax rate=0%</td>
<td>35% or 0%</td>
<td>35%</td>
</tr>
<tr>
<td>2011</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$13,000</td>
<td>$5,000,000</td>
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<td>2012</td>
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<tr>
<td>2013</td>
<td>$5,250,000</td>
<td>$5,250,000</td>
<td>$14,000</td>
<td>$5,250,000</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>2014</td>
<td>$5,340,000</td>
<td>$5,340,000</td>
<td>$14,000</td>
<td>$5,340,000</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>2015</td>
<td>$5,430,000</td>
<td>$5,430,000</td>
<td>$14,000</td>
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<td>40%</td>
<td>40%</td>
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<tr>
<td>2016</td>
<td>$5,450,000</td>
<td>$5,450,000</td>
<td>$14,000</td>
<td>$5,450,000</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>2017</td>
<td>$5,490,000</td>
<td>$5,490,000</td>
<td>$14,000</td>
<td>$5,490,000</td>
<td>40%</td>
<td>40%</td>
</tr>
</tbody>
</table>

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1. 10% surtax added
2. Unified credit replaces exemption
3. The 1st GST Tax was retroactively repealed
4. Graduated rates and unified credit phased out for estates greater than $10,000,000
5. TRA 2010 permitted the executor of the estate of a decedent dying in 2010 to opt out of the estate tax, at the cost of forgoing in large part an adjustment to the cost basis of the decedent's assets at death.
EXHIBIT B
Sample Pre-Post-Nuptial Clauses Regarding Portability

From David Gollin, Minneapolis, MN:

Unused Estate Tax Exclusion Amount. The parties agree that if one party dies during the marriage (regardless of whether dissolution, annulment or legal separation proceedings are pending), the personal representative of the deceased party's estate will, at the surviving party's request, timely file any and all documents necessary to make the election provided in § 2010(c)(5) of the Internal Revenue Code, or any similar or corresponding law, for the deceased spousal unused exclusion amount with respect to the deceased party’s estate to be available to be taken into account by the surviving party and such party's estate (the "Election"). Said documents may include, but are not necessarily limited to, a federal estate tax return for the deceased party's estate even if one would not otherwise be required. If the surviving party requests that the Election be made and the deceased party’s estate would otherwise not be required to file a federal estate tax return or other necessary documents in order to make the Election (the "Return"), the surviving party shall make the arrangements for the preparation of the Return and pay the cost of preparing the Return and all other costs incurred in connection with the Election. The deceased party’s personal representative shall fully cooperate with the preparation, execution and filing of the documents constituting the Return and shall promptly furnish all documents and information as shall be reasonably requested for that purpose.

From Michael Whitty – Chicago Illinois:

Portability of Estate Tax Exemption. While the applicable estate tax law allows for an election to transfer unused estate tax exemption (or, alternatively, applicable credit amount or unified credit) from the estate of the predeceasing spouse to the estate of the surviving spouse, the parties shall maintain wills that authorize and direct executors and personal representatives for the predeceasing spouse to make such elections, and in their discretion to charge the surviving spouse for the incremental cost of filing returns and elections as necessary to effectuate that transfer.

Michael noted, "In a first-marriage-for-each situation, I could see a case for not including this in the premarital agreement. In the case at hand, I have a second marriage situation, each with kids from prior marriages, with the younger spouse well over the estate tax threshold and the older, while not a pauper, well below the threshold. The older spouse's unused exemption could be very valuable to the younger one (i.e. $2MM exemption used, $3MM available for portability, about $1MM estate tax savings for the surviving spouse). From my perspective, if the older spouse's exemption would be largely wasted but for portability, why not be sure that it will be used and not overlooked?

"I have no legal basis to be sure, but I'm hoping that this contractual provision in the premarital agreement would be sufficient to create an obligation for the executor to follow through on the portability election, even if the predeceasing spouse's will is silent."
EXHIBIT C
Sample Letter Regarding Portability

________________________
________________________
________________________

Re: Estate of ________________, Deceased

Dear _________________:

As we have discussed, it does not appear that the preparation and filing of a Federal Estate Tax Return (Form 706) will be required since the value of [your spouse]'s estate does not exceed the threshold for filing a Form 706 for the year [2017] [i.e., $5,490,000]. However, you may elect to have a Form 706 prepared and filed to be eligible to benefit from a new law effective January 1, 2011, which provides for "portability" of [your spouse]'s federal estate tax exemption to you. The Form 706 must be filed within nine (9) months after [your spouse]'s death (or within fifteen (15) months with a timely filed extension). The cost of preparing a Form 706 is typically between [$___ and $___], but may be more or less, depending upon the nature of the estate's assets and resulting complexity of the return.

In effect, portability adds [your spouse]'s unused federal estate tax exemption ("exemption") to the federal exemption available to you, both for federal gift and estate tax purposes. For example, if the total value of [your spouse]'s estate is $1,000,000 and all of the estate passes to the [Family/Bypass] Trust created in [his/her] Will [change statement and numbers if passes outright to spouse or otherwise], $1,000,000 of [his/her] exemption will have been used, leaving [$4,490,000] of unused exemption. If you file the Form 706 in a timely manner, you and your estate will have the ability to use [his/her] [$4,490,000] of unused exemption, plus the amount of your own exemption, for gift and estate tax purposes. Depending on the amount of [your spouse]'s unused exemption, this could substantially increase the gift tax exemption available to you during your lifetime and the estate tax exemption available to you at your death. Continuing the example above, if the exemption is [$5,490,000] upon your death, your estate would have [$9,980,000] of available exemption ([$4,490,000] of [your spouse]'s unused exemption plus your [$5,490,000] exemption).

Please note that one idiosyncrasy of portability is that you are only allowed to use the exemption of your "last deceased spouse." As the statute is written, if you were to remarry, and if your new spouse were to predecease you, you would not be able to use [NAME of decedent]'s excess exemption after that time, even if you filed the Form 706 for [his/her] estate.

[INCLUDE PARAGRAPH BELOW IF SS IS UNDECIDED ABOUT PORTABILITY RETURN]

As a result of current law, it is prudent to plan with the assumption that if the value of your estate, including life insurance death benefits, exceeds the current exemption amount of [$5,490,000] (adjusted for inflation each year), there may be estate taxes payable at the time of your death. Filing a Form 706 for [your spouse]'s estate might reduce or eliminate those taxes. The deadline for filing this Form is _____________. If you want to consider filing the Form 706, please contact me no later than _____________. If we do not hear from you by that date, we will assume that you have decided not to file a Form 706 for portability purposes, and we will not take any steps to prepare the Form 706.

[INCLUDE PARAGRAPHS BELOW IF SS HAS INDICATED HE/SHE DOES NOT WANT TO FILE PORTABILITY RETURN]

If you anticipate that your estate may be in excess of the exemption amount (under current law, this exempt amount is [$5,490,000 for 2017] and is subject to an inflation adjustment each year), it would be prudent to consider filing a Form 706 for [your spouse]'s estate to take advantage of portability. If your estate exceeds this exemption when you die, your estate would owe estate tax (at current rates) equal to 40% of the amount above the exemption. Filing a Form 706 could substantially increase the threshold above which estate taxes would be due.

Pursuant to our conversations with you, you have decided not to file a Form 706 for portability purposes. Accordingly, this letter will confirm our understanding that you do not wish to move forward and we will not take any steps to prepare the Form 706.
EXHIBIT D
Sample Clayton QTIP Trust Language

1. If my [spouse], survives me, and if my Executor (other than my [spouse]), in the exercise of sole and absolute discretion, so elects for some or all of my net residuary estate to qualify for the federal estate tax marital deduction under Section 2056(b)(7) of the Code (the "QTIP election"), I direct that my net residuary estate shall be divided into two portions, to be known as Portion A and Portion B.

   a. Portion A shall consist of that share of my net residuary estate, if any, with respect to which my Executor has made the QTIP election. I give, devise and bequeath Portion A to the Trustee hereinafter named, IN TRUST, to be held as a separate [QTIP] trust and disposed of in accordance with the provisions of paragraph ___ of Article _____.

   b. Portion B shall consist of the balance, if any, of my net residuary estate. I give, devise and bequeath my net residuary estate to the Trustee hereinafter named, IN TRUST, to be held as a separate [Bypass] trust and disposed of in accordance with the provisions of paragraph ___ of Article _____.

2. If my [spouse], survives me, and if my Executor (other than my [spouse]), in the exercise of sole and absolute discretion, does not make a QTIP election with respect to some or all of my net residuary estate, I give, devise and bequeath my net residuary estate to the Trustee hereinafter named, IN TRUST, to be held as a separate [Bypass] trust and disposed of in accordance with the provisions of paragraph ___ of Article _____.

3. Each of Portion A and Portion B is intended to be a fractional share which participates in appreciation and depreciation occurring in the property disposed of under this Article. Subject to the provisions of paragraph ___ of Article _____, each portion may be funded with cash or other property, or a combination thereof, and any such other property so used shall be valued as of the date of distribution.
EXHIBIT E
Sample Exercise of Formula Power of Appointment Triggering the Delaware Tax Trap¹


A. Identification of Power. Under the Last Will and Testament of my deceased [spouse] dated ________, ("my [spouse]'s Will") the ________ Trust (the "Trust") was created for my primary benefit. Pursuant to Section ___ of my [spouse]'s Will, I have a Testamentary Power of Appointment to appoint all of the remaining property of the Trust (outright, in trust, or otherwise) to any one or more of my [spouse]'s descendants.

B. Exercise of Power. I hereby appoint the property described in Subsection ___. below to my children who survive me, in equal shares. However, if any child fails to survive me but leaves one or more descendants who survive me, I give the share that child would have received (if he or she had survived) per stirpes to his or her descendants who survive me. All of the preceding distributions are subject to the provisions of Article ___ (providing for lifetime Descendant's Trusts [that grants the primary beneficiary thereof (or others) a presently exercisable general power of appointment] for my children and other descendants).

C. Extent of Exercise. The foregoing exercise does not apply to the following assets held by the Trust: (i) cash or cash equivalent accounts (such as savings accounts, certificates of deposit, money market accounts or cash on hand in any brokerage or equivalent accounts); (ii) property that constitutes income in respect of a decedent as described in Code Section 1014(c); (iii) any interest in any Roth IRA accounts or Roth variants of other retirement plans, such as Roth 401(k)s, 403(b)s, 457(b) accounts, and the like; and (iv) any interest in any 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 death (the "Excluded Assets"). If, after eliminating the Excluded Assets, the inclusion of the value of the other assets in the Trust in my taxable estate for federal estate tax purposes would not increase the federal estate tax and state death taxes payable from all sources by reason of my death, this power of appointment shall apply to all remaining assets of the Trust other than the Excluded Assets (the "Included Assets"). However, in the event that the inclusion of the value of all of the Included Assets in the Trust in my taxable estate for federal or state estate or inheritance tax purposes would increase the taxes so payable, the assets of the Trust appointed by this Section shall be further limited as follows: The Trustee shall for each of the Included Assets evaluate the ratio of the fair market value at the time of my death to the cost basis immediately prior to my death first (the "Gain Ratio"). The Trustee shall thereafter rank the Included Assets in order of their respective Gain Ratio. The appointment shall apply first to the Included Asset with the largest Gain Ratio, and thereafter in declining order of Gain Ratio to each of the subsequent Included Assets; however, as such point that inclusion of the next in order of the Included Assets would otherwise cause an increase in my estate's federal or state estate tax liability as described above, my appointment pursuant to this Section ___ shall be limited to that fraction or percentage of that Included Asset that will not cause any federal or state estate tax liability, and all lower ranked Included Assets shall be excluded from the exercise of this power of appointment.

D. Statement of Intent. It is my intention by the foregoing exercise of my power of appointment to trigger Code Section 2041(a)(3) by postponing the vesting of an estate or interest in the property which was subject to the power for a period ascertainable without regard to the date of the creation of my power, and to thereby obtain for the assets of the Trust the maximum possible increase in the cost basis of those assets as may be permitted under Code Section 1014 as a result of my death without causing any increase in the federal estate tax and state death taxes payable from all sources by reason of my death. This Will shall be administered and interpreted in a manner consistent with this intent. Any provision of this Will which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent.

¹ This language is loosely adapted from Morrow, "The Optimal Basis Increase and Income Tax Efficiency Trust" available at http://tinyurl.com/qen5gw1 at pp. 86-87.
# Technique Comparison

<table>
<thead>
<tr>
<th></th>
<th>“Income” to Grantor</th>
<th>Decreases Estate</th>
<th>Basis Adjust</th>
<th>GST</th>
<th>Funding?</th>
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<tbody>
<tr>
<td><strong>Outright Gifts</strong></td>
<td>N</td>
<td>Y(^1)</td>
<td>N</td>
<td>N</td>
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<tr>
<td><strong>ILIT</strong></td>
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<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>N/A(^9)</td>
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<td><strong>Sale to Kids</strong></td>
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<td>Y</td>
<td>Y(^2)</td>
<td>N</td>
<td>Note</td>
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<td><strong>Sale to Non-Gr Trust</strong></td>
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<td>Y(^2)</td>
<td>Y</td>
<td>Note</td>
</tr>
<tr>
<td><strong>Sale to IDGT</strong></td>
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<td>N(^3)</td>
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<td>N/A</td>
<td>Note</td>
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<tr>
<td><strong>Accidently Perfect Gr Trust</strong></td>
<td>Y(^1)</td>
<td>Y(^1)</td>
<td>Y(^5)</td>
<td>Y</td>
<td>Note</td>
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<td><strong>GRAT</strong></td>
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<td>Y(^1)</td>
<td>N</td>
<td>N(^6)</td>
<td>Annuity(^8)</td>
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<tr>
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<td>N</td>
<td>N(^6)</td>
<td>Occupancy(^8)</td>
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<td>Y</td>
<td>N(^7)</td>
<td>Y</td>
<td>Remainder?</td>
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<td><strong>CRT</strong></td>
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<td>Y</td>
<td>N(^4)</td>
<td>N(^4)</td>
<td>Ann. or uni.</td>
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<td>N</td>
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<td><strong>Private Annuity</strong></td>
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<td>Y</td>
<td>Annuity</td>
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<tr>
<td><strong>SCIN</strong></td>
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<td>Y, maybe</td>
<td>Maybe</td>
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<td>Note</td>
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<tr>
<td><strong>SLAT</strong></td>
<td>?</td>
<td>Y</td>
<td>N</td>
<td>Y</td>
<td>N/A</td>
</tr>
</tbody>
</table>

1. By appreciation
2. But at cost of capital gain recognition.
3. While grantor trust status stays in place
4. Doesn’t matter
5. At death of powerholder (not at time of transfer), plus 1014(b)(9) issue
6. Not until end of ETIP
7. Funding amt plus growth at AFR, can allocate more at end of term
8. During initial term; with QPRT, rent obligation unless repurchase
9. Hedge technique

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Decision Tree for Sections 25.2704-2 and 25.2704-3 Proposed Regulations
Transfers of Interests to Family Members

1 Family Member = transferor/spouse, ancestor/descendant of transferor or spouse, sibling of transferor, or spouse of foregoing
2 Controlled Entity = control by Family Members and/or descendants of parent of transferor or transferor's spouse
3 Includes Family Members1 and transferor's estate

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*Put = right to receive < Minimum Value† on > 6 months' notice for cash, property or Qualified Note+
†Minimum Value = interest's % share of net value of entity on date of liquidation or redemption
‡Gryphon = a ≥10%, ≥3yr non family1 member owner with a Put* if non-family1 members own ≥20% of business
*Qualified Note = issued by unrelated persons or entity if active trade or business and ≥ 60% = non-passive assets; adequately secured, periodic payments, market interest, FMV = liquidation proceeds

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