PLANNING FOR NEW BASIS AT DEATH

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EDUCATION:

- University of Texas School of Law, J.D. with High Honors, 1982. Chancellors; Order of the Coif; Associate Editor, Texas Law Review; Member, Board of Advocates
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- Adjunct Professor, University of Houston School of Law, 1988–2015, teaching Income Taxation of Trusts and Estates and Postmortem Estate Planning
- Best Lawyers in America, Trusts and Estates
- Named Best Lawyers' 2013 Houston Trusts and Estates "Lawyer of the Year"
- Named by Texas Lawyer as a 2013 "Top Notch Lawyer" for Trusts and Estates
- Admitted to Practice: State Bar of Texas; Federal District Court for the Southern District of Texas; United States Tax Court
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PROFESSIONAL ACTIVITIES:

- Editor, ACTEC Law Journal (2012-2013)
- Member of the Board of Directors, ACTEC Foundation (Chairman: Grant-making Committee)
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RECENT SPEECHES AND PUBLICATIONS:

- Co-Author: Streng & Davis, Retirement Planning–Tax and Financial Strategies (2nd ed., Warren, Gorham & Lamont (2001, updated annually)

  Author/Speaker: Planning for Basis at Death, The University of Texas School of Law 62nd Annual Tax Conference–Estate Planning Workshop, 2014
- Co-Author/Panelist: Evaluating Portability, Potential Problems and the Post-ATRA Planning Paradigm, 40th Annual Notre Dame Tax and Estate Planning Institute, 2014
- Co-Author/Panelist: Directed Trusts and the Slicing and Dicing of the Trustee's Duties, ACTEC 2014 Fall Meeting
- Speaker: Basis Adjustment Planning, State Bar of Texas 38th Annual Advanced Estate Planning and Probate Course, 2014
- Co-Author/Panelist: Recipes for Income and Estate Planning in 2014, State Bar of Texas 20th Annual Advanced Estate Planning Strategies Course, 2014
- Co-Author/Speaker: Income Taxation of Trusts and Estates—Ten Things Estate Planners Need to Know, Southern Arizona Estate Planning Council, 2014
- Co-Author/Panelist: The American Taxpayer Relief Act of 2012 One Year Later, Houston Estate and Financial Forum, 2014
- Author/Speaker: Funding Unfunded Testamentary Trusts, University of Miami 48th Annual Heckerling Institute on Estate Planning, 2014; Texas Society of CPAs Advanced Estate Planning Conference, 2014
- Co-Author/Panelist: Trust and Estate Planning in a High-Exemption World and the 3.8% "Medicare" Tax: What Estate and Trust Professionals Need to Know, The University of Texas School of Law 61st Annual Tax Conference – Estate Planning Workshop, 2013; Amarillo Estate Planning Council 23rd Annual Institute on Estate Planning, 2014
- Author/Speaker: Who Is Your Spouse? The Demise of DOMA and Its Impact on Estate Planning in Texas, Attorneys in Tax and Probate (Houston), 2013
- Author/Speaker: Tax Considerations in Lawsuits and Settlements, Texas Society of CPAs Advanced Estate Planning Conference, 2013
- Co-Author/Speaker: Taxes for Trusts and Estates–New Taxes, New Rates, New Challenges, State Bar of Texas 37th Annual Advanced Estate Planning and Probate Course, 2013
- Co-Author/Speaker: Estate and Trust Planning: Why You Can't Ignore Tax Issues Despite Portability and High Exemptions, Hidalgo County Bar Association, 2013 Probate, Trust & Guardianship Law Course, 2013

TABLE OF CONTENTS

PLANNING FOR NEW BASIS AT DEATH

I. INTRODUCTION

Historically large federal gift and estate tax exemptions plus the availability of portability mean that for many taxpayers, estate and gift taxes are simply no longer a primary concern. At the same time, increased applicable income tax rates have brought a new focus on the importance of income tax planning. The combined effect of these changes has given rise to a new emphasis on maximizing a taxpayer's basis in property acquired from a decedent.

II. THE NEW TAX ENVIRONMENT

A. ATRA Changes to Rates and Exemptions

The American Taxpayer Relief Act of 2012 ("ATRA") was passed by Congress on January 2, 2013 and signed into law on January 4, 2013. As a result, we now have "permanent," unified estate, gift, and generation-skipping transfer tax legislation with some little twists. 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 2014, after applying the inflation adjustment, the exemption is $5,340,000. Easy to remember for the dyslexic among us, the 2015 exemption is projected to be $5,430,00. 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.

B. The Net Investment Income Tax

Coincidentally, although not a part of ATRA, January 1, 2013 also ushered in an entirely new 3.8% income tax. The Health Care and Education Reconciliation Act of 2010 ("HCA 2010") imposes an additional 3.8% income tax on individuals, trusts, and estates. 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 $11,950 for 2013, $12,150 for 2014 and will be $12,300 for 2015. 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

The Tax Reform Act of 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). 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 inherits 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[1] to shelter the gift to the children, and pass (or "port") the other $4 million of H's estate 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).

As a result, married couples can effectively shelter up to $10.86 million (using 2015 figures) in wealth from

[1] 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 outline assumes a $5 million exemption without adjustment for illustration purposes, to make the math easier.

federal gift or estate tax without utilizing any sophisticated estate planning techniques.

III. WHAT IS BASIS?

Basis is a fundamental concept in income tax planning. A taxpayer may recognize taxable income 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. 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 if the property in question is acquired from a decedent. IRC § 1014(a).

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 Section 2032A of the Code. 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, various assets may be stepped up *or down* as of the date of death. 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.

B. 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 fixing 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 past, which make parsing the statute somewhat difficult. In summary, the current list includes the following seven items:

1. 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. 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).

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 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. A helpful test for determining whether an estate must treat an asset as IRD is set forth in *Estate of Peterson v. Comm'r*, 667 F.2d 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 income in respect of a decedent 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 Gift. 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. 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).

D. Contrast Basis in Property Acquired by Gift

Unlike property acquired from a decedent, property acquired by gift (whether the gift is made outright or in trust), generally receives a "carry-over" basis. But, unrecognized losses incurred by the donor do not carry over to the donee. Solely for determining a donee's loss on a sale, the donee's basis cannot exceed the fair market value of the property at the date of the gift. IRC § 1015(a). In other words, if the donor's basis in an asset exceeds its fair market value at the date of the gift, the donee's basis may be one number for purposes of determining gain on a later sale, and another for purposes of determining loss. In either event, the amount of the donee's basis is increased (but not beyond the fair market value of the property) by the amount of any gift tax paid by the donor on the transfer. IRC § 1015(d).

1. Donee's Basis to Determine Gain. For purposes of determining gain (and for purposes of determining depreciation, depletion, or amortization), the basis of property acquired by gift is the same as it would be in the hands of the donor or, in the case of successive gifts, of the last preceding owner by whom it was not acquired by gift. IRC § 1015(a).

2. Donee's Basis to Determine Loss. For purposes of determining a loss on sale, if the fair market value of the property at the time of the gift was less than the donor's adjusted basis, the basis for determining loss is the fair market value as of the time of the gift. *Id*. Fair market value for this purpose is determined in the same manner as it is for purposes of determining the value of the property for gift tax purposes. Treas. Reg. § 1.1015-1(e). The "lower of fair market value or basis" rule does not apply to transfers to a spouse, whether made incident to a divorce or otherwise. IRC § 1015(e). Instead, the basis of the transferee in the property is equal to the adjusted basis of the transferor for all purposes. IRC § 1041(b)(2).

Example 2: X gives stock to Y with a fair market value of $100 and an adjusted basis of $270. The following year, Y sells the stock for $90. Since Y is selling the stock at a loss, Y must use the lesser of X's basis or the stock's fair market value ($100) as the basis, and may recognize a loss of only $10. The $170 loss in value suffered by X is foregone. If instead, Y sold the asset for $150, a paradox arises. If Y were permitted to utilize X's basis of $270, Y would incur a $120 loss on the sale. However, Section 1015 of the Code provides that if a loss would otherwise arise, Y's basis is the lesser of X's basis or the stock's fair market value ($100). But Y's basis cannot be the fair market value on the date of the gift ($100), because fair market value is used as the donee's basis only when a loss would be recognized, and no loss would be recognized if there were a $100 basis in the stock. Therefore, Y recognizes neither a gain nor a loss.

3. The Cost of Foregoing Basis. One of the main transfer-tax advantages of making a gift is that any post-gift appreciation is not subject to estate tax. But, as noted above, one cost of lifetime gifting is that there will be no basis adjustment for the gifted asset at death. As a result, the asset may need to appreciate significantly after the gift in order for the 40% estate tax savings on the appreciation to offset the loss of basis adjustment for the asset. For example, assume a gift is made of a $1 million asset with a zero basis. If the asset does not appreciate, the family will lose the step-up in basis. At a 23.8% effective capital gain rate (if the family members are in the top tax bracket), this means the family will receive a net value of $762,000 from the asset after it is sold. If the donor had retained the asset until death, and if the property does not appreciate, the transfer tax implications would be the same (since the adjusted taxable gift rules under Code Section 2001(b)(1)(B) effective use up an equivalent exemption at death). But if the asset were held at death, the basis adjustment would save $238,000 of capital gain taxes. In order for the estate tax savings on post-gift appreciation to offset the loss of basis adjustment, the asset would have to appreciate from $1,000,000 to $2,469,136 (nearly 147%) (appreciation of $1,469,135 x .40 estate tax rate = gain of $2,469,135 x .238 capital gain rate).[2] Keep in mind that the income tax is incurred only if the family sells the asset. If the family will retain the asset indefinitely, or if real estate investment changes could be made with like-kind exchanges, basis step-up is not as important.

IV. DO OUR OLD PLANNING TOOLS STILL WORK?

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 with estate and gift tax rates exceeding 50%, and capital gain rates at 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.

A. Using Bypass Trusts.

1. 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.

Example 3: 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 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, their children will inherit assets in the bypass trust with a value of $6 million, but with

[2] *See* Carlyn McCaffrey, "Tax Tuning the Estate Plan by Formula," 33 UNIV. MIAMI HECKERLING INST. ON EST. PL. ch. 4, ¶ 403.5 (1999). Mahon, "The 'TEA' Factor," TR. & ESTS. (Aug. 2011).

a basis of only $3. 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 23.6%).[3]

2. Higher Ongoing Income Tax Rates. Single individuals are subject to the highest income tax rates on income in excess of $400,000 ($413,200 in 2015), 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 $12,300 (for 2015), 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 $413,200 ($464,850 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 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 remained single and her taxable income were between $90,750 and $189,300 (or between $129,600 and $200,000 if she remarried—all using 2015 income tax brackets). IRC § 1.

3. Some Assets Cause Greater Tax Burdens. A client's asset mix may impact the importance of these issues. For example, assets such as IRAs, qualified plans, and deferred compensation may give rise to ordinary income taxes without regard to their basis. 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 result to all shareholders of the entity.[4]

Example 4: H has an IRA worth $1 million which earns 6% per year, the beneficiary of which is the trustee of a bypass trust for W. H dies when W is 60 years old. Because the IRA is payable to the trust, W cannot role 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. If instead, the IRA had been payable to W, she could have rolled the IRA over to her own IRA, deferred minimum required distributions until age 70 ½, and used the more favorable unified table for her life expectancy. 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. Since 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, the ability to defer distributions for an additional 10 years would mean that the IRA would hold nearly $4 million!

4. Disclaimer Bypass Trusts. With proper advanced drafting, 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 passes away. 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 DSUE 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 Internal Revenue Code. *See, e.g.*, TEX. ESTS. CODE Chpt. 122; IRC § 2518. The disclaimer must be filed within nine

[3] 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.

[4] *See* Davis, *Income Tax Consequences (and Fiduciary Implications) of Trusts and Estates Holding Interests in Pass-Through Entities*, State Bar of Texas 25th Ann. Adv. Est. Pl. & Prob. Course (2001).

months of the date of death *and* before any benefits of the disclaimed property are accepted. 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, despite the potential tax costs, instead of outright? There are a number of reasons.

1. Control of Assets. A trust allows the grantor to be sure 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 some extent how much (if at all) the surviving spouse can alter the estate plan.

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, these assets would include a homestead or an interest in a retirement plan). Assets inherited in trust are generally all protected from creditors so long as the trust includes a valid "spendthrift" clause. *See, e.g.,* TEX. PROP. CODE § 112.035.

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 protects them from claims of a prior spouse, although spendthrift provisions do not prevent trust assets from being used to pay child support claims. TEX. FAM. CODE § 154.005.

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 spouse from claiming those benefits.

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, 19 states and the District of Columbia impose a separate stand-alone estate or inheritance tax.[5] 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.,* Washington State's RCW 83.100.040 (2013) imposing a 20% state estate tax on estates exceeding $2 million in value).

[5] 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, New York, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont and Washington. See Adirenne M. Penta, *Rest in (Tax-Free) Pease*, 153 TRUSTS & ESTS. 45 (2014).

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 and estate tax exemption to the extent that they exceed the gift tax annual exclusion. 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 the spouse's gift or estate tax exemption or annual exclusion, regardless of their amount.

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) is adjusted beginning in 2012 for inflation after 2010 ($5.34 million in 2014 and $5.43 million in 2015). 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 5: 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 has grown to only about $6.5 million. When combined with the $5 million DSUE amount received from H, her applicable exemption 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 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. 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 $2.1 million or more in additional estate tax (40% of $5.34 million). This risk does not apply if assets are inherited in a bypass trust.

Example 6: 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 2015 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 2014, a couple using a bypass trust can exempt $10.68 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 ($5.34 million in 2014).

Example 7: Assume the same facts as in the Example 5. If portability is used, only $12.7 million after tax ($13.5 million less $800,000 in 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 8: H and W, a married couple with a $10 million estate, leave 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 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 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.

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 need be distributed to the surviving spouse. IRC § 643(b). In measuring fiduciary accounting income, the governing instrument and local law, not the Internal Revenue 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 QTIP election is made under Section 2056(b)(7)(v) of the Code, 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.

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 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 § 20256(b)(7). (*But see* the discussion of Revenue Procedure 2001-38 at page 10 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 DSUE amount, even though the surviving spouse would retain the use of the unreleased income interest. By making a gift of 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). Moreover, because estate tax inclusion arises under Code Section 2036 and not Section 2044, a corresponding adjustment will be made to the surviving spouse's computation of adjusted taxable gifts at death. *See* Treas. Reg. § 20.2044-1, Ex. 5.[6]

Example 9: 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 Code Section 2519. Because the interest retained by H is not a qualified annuity interest, Code Section 2702 precludes any discounts on 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 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 without paying any gift tax by using his or her DSUE amount).

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 used. 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.

[6] This technique is discussed in detail in Franklin and Karibjanian, *Portability and Second Marriages—Worth a Second Look*, 39 EST. GIFT & TRUST J. 179 (2014).

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 applicable 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. Does Revenue Procedure 2001-38 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"?

Commentators have suggested that the Revenue Procedure is simply inapplicable if the surviving spouse or the surviving spouse's executor does not affirmatively invoke it. The Revenue Procedure itself, however, suggests that it may be invoked by "produc[ing] a copy of the estate tax return filed by the predeceased spouse's estate establishing that the election was not necessary to reduce the estate tax liability to zero." When a DSUE amount is utilized, the return on which portability was elected will need to be produced, and any return filed only to elect portability will necessarily show that the QTIP election was not necessary to reduce estate tax. Granted, to obtain relief, the Revenue Procedure also states that "an explanation of why the election should be treated as void" should be included with the return, suggesting that to be treated as void, the taxpayer needs to take affirmative action to request it.

It seems unlikely that a revenue procedure granting administrative relief can negate an election clearly authorized by statute. The regulations regarding portability make explicit reference to QTIP elections on returns filed to elect portability but not otherwise required for estate tax purposes. *See* Treas. Reg. § 20.2010-2T(a)(7)(ii)(A)(4). In the IRS's most recent Priority Guidance Plan, the IRS has indicated that it intends to issue a clear statement about the applicability of the Revenue Procedure in the context of portability. It seems likely that this guidance will authorize QTIP elections even for estates where no estate tax is otherwise due.

5. *Clayton* QTIP Trusts. When the statute authorizing QTIP trusts was first enacted, the IRS strictly construed language in Section 2056(b)(7) requiring the property in question to pass from the decedent. In *Clayton v. Comm'r*, 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. The regulations 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. *Clayton v. Comm'r*, 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 decisions. 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 *Clayton* 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 *Clayton* 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 *Clayton* election. Sample language invoking a *Clayton* QTIP trust is attached as Exhibit A.

If a *Clayton* 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.

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 § 124.003. 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 10: H & 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 his 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 (i.e., her basic exclusion amount plus H's DSUE amount of $5 million) to eliminate the tax. 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 may 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 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), (10).

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 may be shifted to others, a LEPA 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 get the second basis adjustment. The LEPA trust may also be preferred by estate planning advisors that fear that the IRS won't favorably resolve the risk to using QTIP trusts and portability posed by Revenue Procedure 2001-38, discussed above at page 10.

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. This topic is discussed in more detail in section V.B.5 below at page 18.

V. A NEW ESTATE PLANNING PARADIGM

Marital trust planning, whether taking the form of QTIP trusts 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" (or "even 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 its 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, 50 AFTR 2d 82-6134 (ND Ill. 1982), aff'd 735 F2d 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); 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. 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). *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 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[7] has questioned whether there is any real difference between a power that is conferred by the protector and a power held jointly with the protector. If the IRS views them as the same, then the surviving spouse (in this example) would be deemed to hold a general power over *all of the trust assets* in all events, regardless of the size of the estate and *regardless of whether the protector exercised the authority to grant the power*.

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 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

[7] *See* Aucutt, *When is a Trust a Trust?* printed as part of *It Slices, It Dices, It Makes Julienne Fries: Cutting Edge Estate Planning Tools*, State Bar of Texas 20th Ann. Adv. Est. Pl. Strat. Course (2014).

rights of any beneficiary." 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, s*ee* Willms, "Decanting Trusts: Irrevocable, Not Unchangeable," 6 EST. PLAN. & COMMUNITY PROP. L. J. 35 (2013).[8]

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)(3).

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."[9] 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 to not 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.[10] 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).

[8] For a more recent version of this outline, *see* Willms, *Decanting Trusts: Irrevocable, Not Unchangeable*, printed as part of *It Slices, It Dices, It Makes Julienne Fries: Cutting Edge Estate Planning Tools*, State Bar of Texas 20th Ann. Adv. Est. Pl. Strat. Course (2014).

[9] Morrow, *The Optimal Basis Increase and Income Tax Efficiency Trust* printed as part of *Recipes for Income and Estate Planning in 2014*, State Bar of Texas 20th Ann. Adv. Est. Pl. Strat. Course (2014).

[10] 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.

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.[11]

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); Treas. Reg. § 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 exactly which property the power pertains to.[12]

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

[11] 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 business stock or a residence that a beneficiary might move into, but those would be relatively rare situations. Most families would prefer the basis go to depreciable property, which can offset current income, before allocating to stocks, bonds, raw land, family vacation home, etc. Therefore, ultimately a weighting may be optimal, or even a formula based on tax impact, but at the most basic level practitioners would want the GPOA to apply to the most appreciated assets first.

See Morrow, fn. 9, at pp. 21-22.

[12] 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 UNIV. 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.

individual stock positions), but the result would be a well ordered cascade of basis increase.[13]

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."

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 11) 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 with fiduciary duties to adverse beneficiaries is not, by that status alone, considered adverse. *See Est. of Jones v. Comm'*r, 56 TC 35 (1971); *Miller v. U.S.*, 387 F2d 866 (1968); Treas. Reg. § 20.2041-3(c)(2), Ex. 3. 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 the trustee. If a non-adverse party is named, it would be prudent to name alternates in the event the first is deceased or incapacitated.[14]

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,

[13] 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" discussed below, see Exhibit B.

[14] The use of a non-adverse party in this context should be contrasted with the problems under Code Section 2041(b)(1)(C) discussed at page 20-21 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.

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 permit a settlor to provide in the terms of the trust that the interest of a beneficiary in the income or in the principal 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 these provisions do not apply to trusts of which the settlor of the trust is also a beneficiary, Texas law makes clear that a beneficiary of the trust may not be considered to be a settlor, to have made a voluntary or involuntary transfer of the beneficiary's interest in the trust, or to have the power to make 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 will be discussed below.[15]

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

Normally, holding or exercising a limited testamentary power of appointment does not cause estate tax inclusion. 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).[16]

Exercising a 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* 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. Since 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. [17] In addition, some estate

[15] 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).

[16] *See also* Treas. Reg. § 20.2041-3(e). There is a gift tax analog, IRC § 2514(e), but triggering gift tax only increases basis to the extent of gift tax actually paid, so its application is extremely limited.

[17] For a survey of state law provisions, *see* Zaritsky, *The Rule Against Perpetuities: A Survey of State (and D.C.) Law*, specifically pp. 8-10 available at: http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf. *See also* Blattmachr and Pennell, *Using the Delaware Tax Trap to Avoid Generation Skipping Transfer Taxes*, 68 J. OF TAX'N 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

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 restriction, there is usually one method left out of state savings statutes that appears to be available in most states.[18]

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.[19] 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.

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 very precise manner, 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 16 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 B.

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 limited by spendthrift language. 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

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discuss using the DTT for basis planning, the discussion is nevertheless helpful. *See also,* 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 Rule Against Perpetuities*, EST. PL. J. (Feb. 2001); Culler, *Revising the RAP*, PROB. L. J. OF OHIO (Mar./Apr. 2012).

[18] Somewhat ironically, Delaware has amended its Rule Against Perpetuities statute to preclude use of the Delaware Tax Trap for trusts with a zero inclusion ratio for GST purposes, which would include most bypass trusts. 25 DEL. CODE §§ 501, 504.

[19] Treas. Reg. § 20.2041-3(e)(2).

shifting taxable income to other trust beneficiaries, because a presently exercisable general power causes the trust to be treated as a grantor trust as to the beneficiary—the trust's income is taxed to the holder of the power if it is exercisable solely by the power holder. 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 §§ 2041, 1014(b)(4). 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. Note that a "disclaimer bypass" plan would generally not permit use of the DTT since, as noted earlier, disclaiming into the trust 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.

PEG powers might force the next generation to obtain a new cost basis at the expense of foregoing 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.

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 the surviving spouse's control of his or her 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 in GST tax non-exempt trusts without giving rise to this argument by the IRS.[20] However, there is some plausibility to the argument.

1. *Estate of Kurz*. With regard to this issue, the *Estate of Kurz*, 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, for any reason, without affecting her estate, during her lifetime.

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

[20] *See* Morrow, fn. 9, at p. 21.

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.

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.[21]

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.[22] In most cases and estate plans, spouses are unlikely to be making large charitable or marital gifts, so ignoring these adjustments is unlikely to make much if any difference.

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.

VI. OTHER STRATEGIES FOR BASIS ADJUSTMENT

A. Transmuting Separate Property into Community Property

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 low-basis separate property into community property. Doing so ensures that no matter which order the spouses' deaths may occur, the surviving spouse will receive a new cost basis in the property. On the other hand, 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 either 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.

B. 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, with the understanding that 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

[21] Morrow, fn. 9, at p. 37.

[22] *See* Nunan, *Basis Harvesting*, PROB & PROP., (Sept./Oct. 2011) (which includes sample language in appendix with both options).

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.

1. Gifts Received Prior to Death. 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, which 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). A new basis is achieved only if the taxpayer lives for at least one year after receipt of the property.

2. 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.

C. Transferring High Basis Assets to Grantor Trust

An intentionally defective grantor trust 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 intentionally defective grantor trust 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 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.

D. 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.

E. Sales to "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 for the benefit of his or her

parent or a more senior family member. Junior gives low-basis or highly appreciating assets to the trust. Alternatively, junior structures the trust as an intentionally defective grantor trust ("IDGT"), contributes appropriate "seed" money, and loans money to the trust to buy an asset with lots of appreciation potential from junior. Initially, the trust might be set up for the benefit of the senior generation (or for junior's parents and descendants). But 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 the senior generation family member for federal estate tax purposes*. Note that a similar effect could be achieved by having the junior family member 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, allows junior to use less of junior's gift tax exemption (by selling to the IDGT for a note), and allows junior to prescribe the terms of the trust and protect assets from the creditors 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 11: Jenny owns the stock in a closely held business that she thinks is about to explode in value. Her mom Mary's net worth is perhaps $100,000. Jenny recapitalizes the company so that it has 1 voting share and 999 non-voting shares. She then sets up an IDGT for Mary's benefit, 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 to make sure that the sale is respected for income and gift tax 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 her available estate tax exemption. Mary's executor uses some of her GST tax exemption to shelter the trust assets from estate tax when Jenny dies. Despite the fact that Jenny has the lifetime use of the trust 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 low income tax brackets.

Specifics.

1. Structure of the APGT. Although the term "accidentally perfect" distinguishes this trust from an "intentionally defective" trust, there 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 GSTT) exemption to spare. The APGT would typically be structured as an IDGT, and if a sale is involved, it would buy rapidly appreciating assets from the junior family member. It would maintain its grantor trust status 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 APGT, its 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 GSTT benefits) upon the death of the senior family member.

2. Basis Issues. Since the assets of the APGT are included in the estate of the senior family member, 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 happens to be 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 adjustment for the asset should be adjusted to its $1 million value, and not just $100,000. See *Crane v. Comm'r*, 331 U.S. 1 (1947).

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 contributed assets grow faster than the interest rate on the IDGT's note, the excess growth passes back to the grantor of the APGT. The goal of an APGT is the same regardless: The assets ultimately pass back for the benefit of the grantor 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 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, even if the junior family member is treated as the owner of the original trust. *Id.* The regulations thus appear to provide the client with 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" after the death of the senior family member. *See, e.g*,. Hesch et al., "A Gift from Above: Estate Planning on a Higher Plane," 150 TR. & EST., Nov. 2011, at 17; Oshins and Ice, "The Inheritor's Trust™; The Art of Properly Inheriting Property," EST. PL., Sept. 2002, at 419.

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. Thanks to a recent change to the Texas Trust Code, regardless of whether the senior family member exercises her power of appointment, the trust will not be treated as having been created by the junior family member for purposes of applying the Texas spendthrift protection statute. *See* TEX. PROP. CODE § 112.035(g)(3)(B). As a result, the IRS should not be able to 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.

7. GST Tax Issues. The donor can allocate GSTT 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 GSTT 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 with sales to more traditional intentionally defective grantor trusts, 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.

F. Section 754 Elections

Upon a partner's death (or upon the sale or exchange of a partnership interest) the partnership's basis in property owned by the partnership is adjusted under Code Section 743 if the partnership makes (or has in effect) an election under Code Section 754. While the implications and mechanics of Section 754 elections are well beyond the scope of this outline, most commentators agree that it is advantageous to estate beneficiaries to have the partnership make a Section 754 election as of the year of death if the fair market value (and hence basis) of the decedent's interest in the partnership exceeds the decedent's share in the basis of the partnership's assets. If the basis of the transferee partner's partnership interest is greater than the former partner's share of the basis of the partnership's assets, then the election will give the new partner a stepped-up basis in the partnership assets. The basis adjustment is not necessarily tied to the change in basis between the old and new partner; rather, it is a function of the relationship between the basis in the partnership interest and the partnership's basis in its assets which are allocable to that partner. If a partnership does not make a Section 754 election when a partner dies, consider asking the partnership to make the election when the decedent's estate or (former) revocable trust funds bequests by distributing the partnership interest, which might also be an event triggering a basis adjustment.[23]

VII. CONCLUSION

With the enactment of "permanent" estate, gift, and GST laws, much of the uncertainty that has existed for the last several years has been quelled. The simultaneous existence of very large estate tax exemptions that will continue to grow, together with the added permanence of portability and the imposition of higher income tax rates and new income taxes, changes the conversations that we have with clients during the estate planning and the estate administration process. These changes have reduced estate tax savings opportunities for many of our clients, but may bring income tax savings techniques to the fore. The negative impact on income taxes that flow from the use of traditional estate planning tools are now more pronounced. As a result, those techniques may need to be re-evaluated and adapted to minimize their negative impact. Adding features to an estate plan to obtain basis is likely to have increasing importance to our clients. As always, even with permanence, we live in an ever changing but never boring world of estate planning.

[23] See Gorin, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," at section II.O.7.c.iii (available by emailing the author at sgorin@thompsoncoburn.com to request a copy or request to subscribe to his newsletter "Gorin's Business Succession Solutions").

EXHIBIT A

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 B

Sample Exercise of Formula Power of Appointment Triggering the Delaware Tax Trap[24]

2.3. Exercise of Powers of Appointment.

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 2.3.C. 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 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)s, 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 estate tax purposes would increase the taxes so payable, the assets of the Trust appointed by this Section 2.3 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 2.3 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.

[24] This language is loosely adapted from Morrow, "The Optimal Basis Increase and Income Tax Efficiency Trust" available at http://healthcarefinancials.files.wordpress.com/2013/11/optimal-basis-increase-trust-sept-2013.pdf at pp. 86-87.