RECIPES FOR INCOME AND ESTATE TAX PLANNING IN 2014

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CHAPTER 1

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- Co-Author/Speaker: *The Brave New World of Estate Planning*, San Antonio Estate Planners Council's Docket Call in Probate Court, 2014
- Comment letter to Department of Treasury on behalf of the Tax Section of the State Bar of Texas on proposed regulations regarding reporting of net investment income tax by trustees of charitable remainder trusts, February 20, 2014
- Author: *Decanting Trusts: Irrevocable, Not Unchangeable*, 6 EST. PLAN. & COMMUNITY PROP. L.J. 35, 2013
- Author: *What Happens After Death?*, The Houston Lawyer, Nov./Dec. 2013 issue
- 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
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- Co-Author/Speaker: *Planning for No Probate: Special Issues with Revocable Trusts and Nonprobate Assets*, Hidalgo County Bar Association, 2013 Probate, Trust & Guardianship Law Course, 2013
- Testimony at public hearing before the United States Department of Treasury and Internal Revenue Service on proposed Section 1411 regulations concerning net investment income tax, Washington, D.C., April 2, 2013
- Comment letter to Department of Treasury on behalf of the Tax Section of the State Bar of Texas on proposed regulations regarding net investment income tax under Section 1411 of the Internal Revenue Code, March 4, 2013
- Author/Speaker: *Living with the "New" Estate Tax*, Houston Bar Association, Probate, Trusts and Estates Section, 2013
- Author: *Decanting Irrevocable Trusts*, Texas Tax Lawyer, Fall 2012 issue
- Author/Speaker: *Estate Planning Pitfalls*, Houston CPA Society 26th Annual Personal Financial Planning Conference, 2012
- Author/Speaker: *Trust Decanting: Why, What, How . . . and More*, Texas Bankers Association, Advanced Trust Forum, 2012
- Author/Speaker: *Decanting Irrevocable Trusts*, State Bar of Texas 36th Annual Advanced Estate Planning and Probate Course, 2012
- Comment letter to Department of Treasury on behalf of the Tax Section of the State Bar of Texas concerning transfers by a trustee from an irrevocable trust to another irrevocable trust (sometimes called "Decanting"), May 22, 2012
- Co-Author/Panelist: *Planning for No Probate: Special Issues with Revocable Trusts and Nonprobate Assets*, State Bar of Texas 18th Annual Advanced Estate Planning Strategies Course, 2012
- Panelist: *Basic Estate Planning*, State Bar of Texas Annual Building Blocks of Wills, Trusts and Estate Planning/Live Satellite Broadcast, 2012

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RECIPES FOR INCOME AND ESTATE TAX PLANNING IN 2014:

I. INTRODUCTION

After the flurry of estate planning and the rush of year-end projects in 2012, the American Taxpayer Relief Act of 2012 ("ATRA 2012") 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. Coincidentally, January 1, 2013 also ushers in a new income tax affecting trusts and estates. So, what are the rules? What does all of this mean for clients? What does it mean for estate planners? Lastly, what do we look for in 2013? Read on to learn more.

II. FEDERAL ESTATE, GIFT AND GST TAX LAWS

Somewhat surprisingly, but definitely welcomed, the new legislation keeps a *unified* estate, gift, and generation-skipping transfer ("GST") tax system.

A. Permanent, Unified Tax System.

1. Historical Perspective. Prior to 2002, each person had a "unified" transfer tax credit which could be used to offset estate and gift taxes. IRC §§ 2010, 2505. This credit effectively sheltered a set amount of transfers (by gift or at death) without incurring any transfer tax. The Economic Growth and Taxpayer Relief Reconciliation Act of 2001 ("EGTRRA") "de-unified" the estate and gift tax credit, with the estate tax exemption exceeding the $1 million lifetime gift tax exemption from 2004 through 2009. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312 ("TRA 2010") re-unified the estate, gift and GST tax exemptions, increasing them to $5 million for 2011, with an inflation adjustment for 2012. In 2013, the law was scheduled to revert to the law in effect in 2001, immediately prior to the enactment of EGTRRA. ATRA 2012, however, made the changes to the gift, estate and GST exemptions from TRA 2010 "permanent," while increasing the effective rate on the excess from 35% to 40%. As a result, we 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 tax bracket of 40%. For 2014, after applying the inflation adjustment, the exemption is $5,340,000. For reference, a chart outlining the estate exemption over the last several years is as follows:

Year of Death	Applicable Exemption or Exclusion Amount	Top Marginal Rate
1997	$600,000	55%
1998	$625,000	55%
1999	$650,000	55%
2000	$675,000	55%
2001	$675,000	55%
2002	$1,000,000	50%
2003	$1,000,000	49%
2004	$1,500,000	48%
2005	$1,500,000	47%
2006	$2,000,000	46%
2007	$2,000,000	45%
2008	$2,000,000	45%
2009	$3,500,000	45%
2010	$5,000,000 or unlimited[1]	35% or 0%
2011	$5,000,000	35%
2012	$5,120,000	35%
2013	$5,250,000	40%
2014	$5,340,000, as adjusted for inflation	40%

2. American Taxpayer Relief Act of 2012, P.L. 112-240. ATRA 2012 really adds only three main items of substance. First, the highest bracket is now 40%. Second, a technical correction is made to correct the clawback potential in the case of portability. Third, the law is now permanent. The result is that we 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 tax bracket of 40%. For clients, the continued inflation adjustment of the exemption amount is another welcomed surprise.

3. Permanency. As we all know, tax laws are never truly permanent. However, for the first time since 2001, there is no set expiration date for the estate,

[1] TRA 2010 permitted the executor of the estate of a decedent dying in 2010 to opt out of the estate tax, at the cost of foregoing in large part an adjustment to the cost basis of the decedent's assets at death.

gift and GST laws. Prior to this year, there was continued uncertainty about "will they or won't they," while now, it literally takes an act of Congress to make a change. Now that we do have permanent law, it is ever more important that existing testamentary plans be reviewed to insure the amount that clients want to pass to their beneficiaries is the right amount. As the exemption amount continues to be adjusted for inflation, specific bequests tied to the exemption amount may become even trickier.

4. Clawback. Since the enactment of TRA 2010, estate planners and their clients have been concerned about the possibility of "clawback." Actually, the concerns regarding clawback have arisen in two areas– portability and traditional transfer taxes. For portability, the concern centered around the use of the term "basic exclusion amount" as used in two places in the statute. IRC § 2010(c)(4). ATRA 2012 revised the statute so that the term used in IRC § 2010(c)(4)(B)(i) is now the "applicable exclusion amount." By Treasury regulation, the term "basic exclusion amount" as used in IRC § 2010(c)(4)(A) is read to mean the basic exclusion amount calculated at the time of the death of the last deceased spouse of a surviving spouse. Temp. Reg. § 20.2010-2T(c)(1)(i). With these two "corrections," the concern regarding clawback in relation to portability is eliminated.

For estate and gift tax purposes, the concern regarding clawback centered around the potential difference between the amount of the gift tax exemption in the year that a gift was made and the amount of the estate tax exemption in the year of the death of the donor. In other words, if a taxable gift was made in a year when the exemption was greater than in the year of the donor's death and then adjusted taxable gifts were added back into the donor's estate for estate tax purposes, the estate would have to use the lower estate tax exemption which might not even cover the adjusted taxable gifts! With the enactment of ATRA 2012, because the exemption amount does not decrease but instead continues to increase each year, this issue of clawback in relation to gifting goes away. In addition, because the issue of this form of clawback was raised so vociferously following TRA 2010, one would expect that any future legislation which decreases the exemption will expressly address this issue.

B. Portability. TRA 2010 added, and ATRA 2012 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 surviving spouse inherits any unused federal estate tax exemption of the deceased spouse, i.e. 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 his or her 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." To understand how portability works, assume, for example, that H dies in 2011 with an estate of $3 million. He leaves $2 million to his wife W, and the balance to his children. As a result, his taxable estate is $1 million. H's executor could elect to file an estate tax return using $1 million of H's $5 million estate tax exemption[2] to shelter the gift to the children, and pass 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).

1. Disadvantages of Portability vs. Bypass Trusts. While portability will be a beneficial "second best" choice for estates of decedents who did no estate tax planning, most estate planners will often continue to recommend bypass trust planning as the best alternative for married couples with potentially taxable estates. This is so for a variety of reasons:

a) <u>Need to Elect</u>. Portability works only if H's executor files an estate tax return electing to pass the unused exemption to the spouse. IRC § 2010(c)(5). Executors of relatively modest estates may see the cost of filing a complete estate tax return as a high price to pay to get the potential benefit of portability.

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

c) <u>No Shelter of Growth</u>. Assets passing to the bypass trust are exempt from estate tax at the second

[2] Although the surviving spouse's exemption amount would be adjusted each year for inflation, the $4 million DSUE amount would not. This outline assumes a $5 million exemption for illustration purposes, to make the math easier.

death regardless of the value of those assets at that time. Thus, a spouse could pass up to $5 million worth of property ($5.34 million in 2014) to a bypass trust, and all of those assets, *plus appreciation*, would pass to the next generation free of tax. Portability provides the surviving spouse only with the unused exemption amount, unadjusted for inflation or growth. At the same time, keep in mind that although the growth in a bypass trust is sheltered from estate tax at the second death, the assets in the trust will not receive a new basis (whether stepped up or down) at second death.

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

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

2. Use with Bypass Trusts—It's Not "Either/Or." Don't forget that bypass trust planning and portability are not "either/or" propositions. Even if the decedent's Will included a bypass trust, the executor may still need to consider whether to make a portability election. If the estate of the first spouse is not large enough to use his or her full exemption amount, if the bypass trust is not fully funded, or if for any other reason there is any "excess" exemption, it may be smart to elect portability in addition to utilizing a bypass trust.

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

4. Temporary and Proposed Regulations.[3] Portability temporary and proposed regulations were issued on June 15, 2012. There are a few new general regulations for Sections 2010 and 2505 of the Internal Revenue Code (the "Code"). (Interestingly, regulations were never previously issued for those statutes.), The newly issued regulations primarily provide guidance regarding portability. The regulations provide guidance on a variety of issues including election requirements, details regarding computing the DSUE amount, and the surviving spouse's use of the unused exclusion amount (either by gifts or for estate tax purposes following the surviving spouse's death).

The regulations generally provide very taxpayer-friendly positions regarding a variety of issues (surprisingly friendly as to several issues). The regulations adopt reasonable positions, avoiding what would seem to be nonsensical results that might occur with respect to various issues under a literal reading of the portability statutes. Perhaps the specific authorization in Section 2010(c)(6) of the Code for the Secretary of the Treasury to prescribe regulations necessary or appropriate to carry out that subsection afforded comfort in interpreting the statutory language very broadly in order to reach reasonable results.

The regulations apply to estates of decedents who died on or after January 1, 2011.

[3] The discussion on the temporary and proposed regulations on portability is derived from Akers, "Portability Temporary and Proposed Regulations (Issued June 15, 2012)," Copyright © 2012 Bessemer Trust Company, N.A. All rights reserved. (used with the permission of the author). The discussion was modified and has since been updated by the authors to reflect statutory changes as a result of the enactment of ATRA 2012.

5. Overview of Regulatory Provisions and Observations.

a) Making the Portability Election.

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

(2) Will Language Regarding Portability. Portability is relatively new and only recently permanent. Consequently, most existing Wills do not contemplate the possibility of preparing an estate tax return if the decedent's estate is not taxable. In most existing Wills, no provision permits the executor to prepare the return and no provision directs whether the estate may or may not pay for the preparation of the return. It is easy to imagine situations where a conflict exists as to whether the return should be prepared, such as multiple beneficiaries of the decedent's estate or where the surviving spouse is not a beneficiary of the decedent's estate and the estate passes to the decedent's children (think blended families). After all, portability has the potential to benefit the beneficiaries of the surviving spouse's estate who may not be the same as the beneficiaries of the decedent's estate. In certain circumstances, making the portability election may actually expose the beneficiaries of the first decedent's estate to unnecessary estate taxes (see the discussion of "The QTIP Tax Apportionment Trap" at page 38 below). Estate planners should discuss the issues with their clients and consider adding language in testamentary documents to direct or prohibit the preparation of the return. If the return may be prepared, then the mechanics of doing so and how the associated costs will be paid should also be addressed. For example, one might consider adding language to the Will which provides, in effect:

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

(3) Timely Filed Estate Tax Return. The regulations make it clear that the last return filed by the due date (including extensions) controls. Before the due date, the executor can supersede the election made on a prior return. After the due date, the portability election (or non-election) is irrevocable. Temp. Reg. § 20.2010-2T(a)(4). The regulations do not discuss whether so-called "9100 relief" to make a late election may be available. However, the IRS has promulgated a simplified method to obtain an extension of time to elect portability in certain cases under Code Section 2010(c)(5)(A). The simplified method only applies where the taxpayer is the executor of the estate of a decedent who has a surviving spouse, the decedent died after December 31, 2010 and on or before December 31, 2013, and the decedent was a U.S. citizen or resident on the date of death. The taxpayer must also not have been required to file an estate tax return under Code Section 6018(a) based on the value of the gross estate plus adjusted taxable gifts (i.e., not more than $5,000,000 in 2011; $5,120,000 in 2012; or $5,250,000 in 2013), and did not file a return in order to elect out of portability. Rev. Proc. 2014-18, 2014-7 IRB 513. In order to obtain this relief, the estate tax return electing portability must be filed not later than December 31, 2014, and must state at the top of the return that it is being "FILED PURSUANT TO REV. PROC. 2014-18 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)." *Id.* Note that if the surviving spouse has also died and the executor of the surviving spouse's estate filed an estate tax return and paid tax, any claim for refund as a result of the late filing of a portability return for the first spouse must be filed within the three-year statute of limitations for the return of the second spouse to die. *Id*. The Revenue Procedure confirms that taxpayers failing to qualify for relief may, after January 1, 2015, request an extension of time to make an election by requesting a letter ruling seeking 9100 relief. Taxpayers with 9100 relief rulings pending when the Revenue Procedure was issued (January 27, 2014) are permitted to rely on the Revenue Procedure, withdraw their ruling requests, and receive a refund of their user fees, so long as the request was withdrawn before the earlier of IRS action on the request or March 10, 2014. *Id*.

(4) Election on Return. The election is made by filing a "complete and properly-prepared" estate tax return. There is no box to check or statement to attach to the return to make the election. For decedents dying after 2011, Part 6 on page 4 of Form 706 addresses the portability election and also includes a box to check to opt out of portability. Of course, another way of not making the election for estates below the filing threshold is to simply not file a return. Temp. Reg. § 20.2010-2T(a)(2)-(3). When the Treasury was drafting its regulations, some comments asked them to give guidance about protective portability elections. For example, if there is a will contest, the DSUE amount may depend on who wins the contest. Until the contest is resolved, there may be no way of knowing who the executor is, or even who is in actual or constructive possession of property unless the court appoints a temporary executor. The regulations have no discussion of protective elections.

(5) "Executor" Permitted to Make Election. If there is a court-appointed executor, that person must make the election. The election may not be made by the surviving spouse if someone else is appointed as the executor. (The regulations do not address the situation of having multiple court-appointed co-executors. Temp. Reg. § 20.2010-2T(a)(6)(i). Presumably the rules for filing estate tax returns would apply, which generally require that all co-executors join in signing the return.) If there is no court-appointed executor (and presumably only if there is no court-appointed executor), any person in actual or constructive possession of property may file the estate tax return on behalf of the decedent and elect portability (or elect not to have portability apply). Any portability election made by a non-appointed executor cannot be superseded by a subsequent election to opt out of portability by any other non-appointed executor. Temp. Reg. § 20.2010-2T(a)(6)(ii). If there is no court-appointed executor and if the spouse is in actual or constructive possession of property of the decedent, the spouse would be able to file a return making the portability election, and no other individual would be able to supersede that election with a return opting out of the election.

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

(7) Relaxed Requirements for "Complete and Properly-Prepared" Return. A "complete and properly-prepared" return is generally one that is prepared in accordance with the estate tax return instructions. However, there are relaxed requirements for reporting values of certain assets. For assets that qualify for a marital or charitable deduction, the return does not have to report the *values* of such assets, but only the description, ownership, and/or beneficiary of the property together with information to establish the right to the deduction. However, the values of assets passing to a spouse or charity must be reported in certain circumstances (where the value relates to determining the amounts passing to other beneficiaries, if only a portion of the property passes to a spouse or charity, if there is a partial disclaimer or partial QTIP election, or if the value is needed to determine the estate's eligibility for alternate valuation, for special use valuation, or for Section 6166 estate tax deferral). Temp. Reg. § 20.2010-2T(a)(7)(ii)(A).

In any event, the executor must exercise "due diligence to estimate the fair market value of the gross estate" including the property passing to a spouse or charity. The executor must identify the range of values within which the "executor's best estimate" of the gross estate falls. Until the estate tax return is finalized to include those ranges of value, the return must state the "executor's best estimate, rounded to the nearest $250,000." Temp. Reg. § 20.2010-2T(a)(7)(ii)(B).

Observation: The regulations provide little further detail regarding what extent of "due diligence" is required. The Preamble to the regulations states that the inquiry required to determine the executor's best estimate "is the same an executor of any estate must make under current law to determine whether the estate has a filing obligation…" Apparently, the required due diligence means something less than obtaining full-blown formal appraisals. In most situations, the executor will need to obtain valuation information in any event to support the amount of any basis step up under Section 1014, for purposes of preparing an accurate probate inventory, and perhaps for state estate tax purposes if there is a state estate tax. Various examples are provided in the Temporary Regulations. Temp. Reg. § 20.2010-2T(a)(7)(ii)(C).

(8) A Portability Return is Still an Estate Tax Return. Keep in mind that even if certain valuation requirements are relaxed when a return is filed for purposes of making a portability election, the normal requirements for preparing and filing an estate tax return still need be observed. Thus, for example, if the executor intends to make a QTIP election (or any other election required to be made on an estate tax return), the QTIP election must be made on the Form 706 filed to make the portability election. For a discussion of Revenue Procedure 2001-38 and its impact on an executor's ability to make a QTIP election in an estate below the filing threshold, see the discussion beginning on page 37 below.

b) Computation of DSUE Amount.

(1) Statutory Provision. As mentioned above, prior to ATRA 2012, Section 2010(c)(2) of the Code seemed to limit the DSUE amount by reducing the deceased spouse's exemption by the amount of their taxable estate. An important change made by ATRA 2012 was to revise Section 2010(c)(4)(B) so that the term "basic exclusion amount" now reads "applicable exclusion amount." Prior to this statutory change, the IRS reached this same result by simply writing the corrective language into its regulations. Temp. Reg. § 20.2010-2T(c)(1) (the bracketed language is added by § 20.2010-2T(c)(2)). The effect of this change is to increase the DSUE by:

> [t]he DSUE amount of each other deceased spouse of the surviving spouse, to the extent that such amount was applied to one or more taxable gifts of the surviving spouse.

Temp. Reg. §§ 20.2010-3T(b), 25.2505-2T(c). This favorable approach allows a taxpayer to utilize the DSUE amount of prior spouses first by making gifts during his or her lifetime without being treated as using his or her own basic exemption amount.

As an overly simplified example, assume that H1 dies, leaving an unused exclusion amount of $2 million. Assume that W remarries and predeceases H2. After H's death, W makes a taxable gift of $1.5 million. In calculating the DSUE amount that H2 receives from W, the $1.5 million gift gets subtracted from the DSUE amount that W received from H1. Example 3 of the Joint Committee on Taxation Technical Explanation of TRA 2010 says that H1's DSUE amount is used first, and the statute concurs. A computation of the DSUE amount from W would start with her basic exclusion amount *plus the DSUE amount from H1*. As a result, even though W can never leave H2 more than her basic exclusion amount, the DSUE amount from H1 is included in the math that measures the impact of W's taxable gifts. In effect, that means that H2 can indirectly benefit from the DSUE amount that W receives from H1.

(2) Adjustment to Omit Adjusted Taxable Gifts on Which Gift Taxes Were Previously Paid. If the decedent paid a gift tax on prior gifts, the regulations provide that those gifts are excluded from the computation of the DSUE amount. This reaches a fair result.

Under the literal statutory language, if an individual makes lifetime gifts in excess of the gift tax exclusion amount, the excess reduces the DSUE amount for that individual's surviving spouse, even though the individual had to pay gift tax on that excess gift amount.

The second "lesser of" element in computing the DSUE amount is:

> the excess of-- (A) The decedent's applicable exclusion amount; over (B) The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent….

Temp. Reg. § 20.2010-2T(c)(1). Under the statute, there is no distinction for adjusted taxable gifts that were subject to actual payment of gift tax.

The regulations add that solely for purposes of computing the DSUE amount, the amount of adjusted taxable gifts "is reduced by the amount, if any, on which gift taxes were paid for the calendar year of the gift(s)." Temp. Reg. § 20.2010-2T(c)(2). An example clarifies that this means "the amount of the gift in excess of the applicable exclusion amount for that year." Temp. Reg. § 20.2010-2T(c)(5), Ex. 2.

This is a very desirable and just result, even if the construction requires that the regulation effectively read additional words into the statute.

(3) Other Credits. Some commentators asked for clarification as to whether the DSUE amount is determined before or after the application of other available credits. This issue is still under consideration, and the regulation reserves a space to provide future guidance. Temp. Reg. § 20.2010-2T(c)(3).

c) Last Deceased Spouse. The regulations reiterate that the "last deceased spouse" means "the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse." Temp. Reg. § 20.2010-1T(d)(5). The regulations confirm that if no DSUE amount is available from the *last* deceased spouse, the surviving spouse will have no DSUE amount even if the surviving spouse previously had a DSUE amount from a previous decedent. Temp. Reg. §§ 20.2010-3T(a)(2), 25.2505-2T(a)(2). (However, as discussed below, DSUE amounts from previous deceased spouses are included to the extent the surviving spouse made *gifts* using DSUE amounts from prior deceased spouses.) The surviving spouse's subsequent marriage by itself has no impact unless the subsequent spouse predeceases, and therefore becomes the new "last deceased spouse." If there is a subsequent marriage that ends in divorce or annulment, the death of the ex-spouse will not change the identity of the last deceased spouse. Temp. Reg. §§ 20.2010-3T(a)(3), 25.2505-2T(a)(3).

d) When DSUE Amount Can be Used. The surviving spouse can make use of the DSUE amount any time after the first decedent's death. The portability election applies as of the date of the decedent's death, and the DSUE amount is included in the surviving spouse's applicable exclusion amount with respect to any transfers made by the surviving spouse after the decedent's death. Temp. Reg. § 20.2010-3T(c)(1). There is no necessity of waiting until after an estate tax return has been filed electing portability. Presumably, the surviving spouse could make a gift the day after the last deceased spouse's death, and the DSUE amount would be applied to that gift. As can be seen by the following discussion, it may be advantageous for a surviving spouse to consider using the deceased spouse's unused exclusion amount with gifts as soon as possible (particularly if she remarries so that she does not lose it if the new spouse predeceases).

The surviving spouse's applicable exclusion amount will not include the DSUE amount in certain circumstances, meaning that a prior transfer may end up not being covered by the expected DSUE amount when the surviving spouse files a gift or estate tax return reporting the transfer. For example, if the executor eventually does not make a portability election, the DSUE amount is not included in the surviving spouse's applicable exclusion amount with respect to those transfers. This is the case even if the transfer was made in reliance on the availability of a DSUE amount such as if the executor had filed an estate tax return before the transfer was made, but subsequently superseded the portability election by filing a subsequent estate tax return before the filing due date opting out of the portability election. Similarly, the DSUE amount would be reduced to the extent that it is subsequently reduced by a valuation adjustment or correction of an error or to the extent the surviving spouse cannot substantiate the DSUE amount claimed on the surviving spouse's gift or estate tax return. Temp. Reg. § 20.2010-3T(c)(1).

e) Gifts by Surviving Spouse.

(1) Generally — DSUE Amount Included in Surviving Spouse's Applicable Exclusion Amount for Gift Tax Purposes. If the surviving spouse makes gifts any time after the last deceased spouse's death, his or her applicable exclusion amount that is used to determine the gift tax unified credit will include the DSUE amount. Temp. Reg. § 25.2505-2T(a)(1).

(2) Last Deceased Spouse Determined at Time of Gift. The "last deceased spouse" is determined at the time of the gift. The DSUE amount from that spouse is used to determine the applicable exclusion amount with respect to that gift, even if a subsequent spouse of the donor dies before the end of the year. Temp. Reg. § 25.2505-2T(a)(1)(i). Without this rule, the DSUE amount from the subsequent spouse who died before the end of the year in which the gift was made would generally apply, because Code Section 2505(a)(1) (quoted above) says that the gift tax unified credit is based on the applicable exclusion amount that would apply "if the donor died as of the end of the calendar year." Accordingly, if a surviving spouse wishes to make gifts to utilize the DSUE amount from a deceased spouse, the donor should make the gift as quickly as possible to assure that the DSUE amount from that particular last deceased spouse is utilized.

The rule has a potentially detrimental effect from a taxpayer-point of view. A donor who is married to an individual who is expected to die in the near future cannot make a gift utilizing an anticipated DSUE amount from that individual, even if the individual dies before the end of the calendar year. (Yes, you have to wait for your spouse to actually die before you can use his or her DSUE amount). If the donor's unified gift tax credit were determined based upon the donor's applicable exclusion amount determined as of the end of the calendar year without this special rule, no DSUE amount from the deceased spouse would be available to offset gifts made by the donor-spouse any time during that calendar year.

(3) Ordering Rule. The regulations include an ordering rule, providing that if a surviving spouse makes a gift with a DSUE amount from the last deceased spouse determined at the time of the gift, "such surviving spouse will be considered to apply such DSUE amount to the taxable gift before the surviving spouse's own basic exclusion amount." Temp. Reg. § 25.2505-2T(b).

Observation. This ordering rule is extremely important and very taxpayer-friendly, as a result of other positions taken in the regulations. As long as the donor does not have a new last deceased spouse, as mentioned above, the donor's applicable exclusion amount will include his or her basic exclusion amount plus the DSUE amount from the deceased spouse. If the donor does have a new last deceased spouse, there could be a risk that the donor would have used some of his or her own basic exclusion amount and would lose the benefit of the DSUE amount from the prior deceased spouse. The special rule discussed immediately below, to add the DSUE amount from a prior last deceased spouse in calculating the DSUE amount, applies only to the extent that the DSUE amount from a prior deceased spouse was applied to taxable gifts of the surviving spouse. Without this ordering rule, the prior deceased spouse's DSUE amount may not have been applied to previous taxable gifts of the surviving spouse, and therefore might not be added to the DSUE amount of the surviving spouse.

(4) Gifts Utilizing DSUE Amounts from Multiple Deceased Spouses is Permitted. An incredibly taxpayer-favorable position in the regulations permits the use of DSUE amounts from multiple deceased spouses. Again, because the statute was not amended by ATRA 2012 to revise any of the taxpayer friendly positions taken in the regulations, presumably Congress has tacitly approved these regulatory interpretations.

The regulations provide that, for both estate and gift tax purposes, if the surviving spouse has applied DSUE amounts to gifts from prior deceased spouses who are different than the last deceased spouse at the time of a particular gift or estate transfer, then the DSUE amount to be included in determining the applicable exclusion amount of the surviving spouse at the time of [the surviving spouse's death][the current taxable gift] is the sum of —

> (i) The DSUE amount of the surviving spouse's last deceased spouse …; and
>
> (ii) The DSUE amount of each other deceased spouse of the surviving spouse, to the extent that such amount was applied to one or more [taxable gifts] [previous taxable gifts] of the surviving spouse.

Temp. Reg. §§ 20.2010-3T(b), 25.2505-2T(c) (the bracketed phrases are in the respective estate tax and gift tax regulations).

This special rule means that an individual can take advantage of DSUE amounts from multiple spouses, as long as the individual makes a taxable gift to utilize the DSUE amount from a particular deceased spouse before the individual is predeceased by a subsequent spouse. Without this special rule, the aggregate DSUE amount that could possibly be used would be limited to the highest single basic exclusion amount that applied at the deaths of any of the deceased spouses.

Example 1. Consider the straightforward example of H1 dying with $5 million of unused exemption, and W makes a gift of $10 million after H1 dies, all covered by her gift tax exemption amount (which includes her basic exclusion amount plus the DSUE amount from H1). Assume W then marries H2 (who is poor and in poor health) who also predeceases W, leaving her his DSUE amount of $5 million (for this simple example, ignore indexing increases to the basic exclusion amount). Can W make another $5 million gift without paying gift tax? Because of the regulations, yes!

Example 2. Consider the same example, but assume that W made only a $5 million gift before marrying H2, and that the ordering rule of the regulations applies to allocate H1's DSUE amount against that $5 million gift. After W marries H2 and he dies leaving her an additional $5 million of DSUE amount, can W make another $5 million gift without paying gift tax? Again, because of the special rule in the regulations, yes.

Observation. Of all of the surprising very favorable positions in the regulations, this is probably the biggest surprise. The "black widow" situation that underlies limiting the DSUE amount to one additional basic exclusion amount, no matter how many deceased spouses a "black widow" has, still exists to the extent that an individual is able to make gifts following the deaths of each of the deceased spouses to take advantage of the unused exclusion from each decedent.

f) Nonresidents Who are Not Citizens.

(1) Decedent Nonresident. If a decedent is a nonresident and not a citizen of the United States, that estate cannot make a portability election. No DSUE amount is available to the surviving spouse of that nonresident decedent. Temp. Reg. § 20.2010-2T(a)(5). The Preamble does not offer an explanation for this conclusion, but it is correct. The portability rules of Section 2010 are in Subchapter A of Chapter 11 of the Internal Revenue Code, which Subchapter is titled "Estates of Citizens or Residents." Subchapter B, titled "Estates of Nonresidents Not Citizens" contains no discussion of the portability concept.

(2) Nonresident Surviving Spouse. A surviving spouse of a decedent may not make any use of the DSUE amount for that person's last deceased spouse any time the surviving spouse is a nonresident/noncitizen for either estate or gift tax purposes, unless allowed under an applicable treaty. Temp Reg. §§ 20.2010-3T(e), 25.2505-2T(f). Apparently, if the surviving spouse subsequently becomes a resident or citizen, that individual then could utilize the DSUE amount for subsequent gifts or at the individual's death when the individual was a resident or citizen. Therefore, even when the surviving spouse is a nonresident, he or she (or the executor) should consider filing an estate tax return in order to make the portability election.

(3) Qualified Domestic Trusts. If a decedent who is survived by a non-resident spouse transfers property to a qualified domestic trust ("QDOT"), the estate is allowed a marital deduction. When distributions are made from the QDOT or when trust assets are distributed at the termination of the QDOT, an estate tax is imposed on the transfers as the *decedent's* estate tax liability. Accordingly, subsequent transfers from a QDOT would reduce the amount of the decedent's unused exclusion amount.

The regulations provide that when a QDOT is created for the surviving spouse, the executor of the decedent's estate who makes the portability election will compute a preliminary DSUE amount that may decrease as distributions constituting taxable events under Section

2056A are made. The surviving spouse will not be able to make any use of the DSUE amount from the decedent who created a QDOT until the date of the event that triggers the final estate tax liability of the decedent under Section 2056A with respect to the QDOT. That typically would not be until the surviving spouse's subsequent death, or until there is a terminating distribution of all of the assets of the QDOT to the surviving spouse during his or her lifetime. Temp Reg. §§ 20.2010-3T(c)(2), 25.2505-2T(d)(2).

g) Statute of Limitations For Considering Determination of DSUE Amount. Section 2010(c)(5)(b) provides that the IRS "may examine a return of the deceased spouse" to make determinations in carrying out the portability provisions without regard to any period of limitations under Section 6501. The regulations confirm that the IRS may examine the returns of each previously deceased spouse whose DSUE amount is claimed to be included in the surviving spouse's applicable exclusion amount at the time of any transfer by the surviving spouse, regardless of whether the period of limitations on assessment has expired on such returns. The IRS may adjust or eliminate the DSUE amount based on such examination, but it may not assess additional estate tax against a prior deceased spouse's return unless the applicable period of limitations on assessment of estate tax is still open. Temp. Reg. §§ 20.2001-2T(a), 20.2010-2T(d), 20.2010-3T(d), and 25.2505-2T(e).

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

III. Additional Income Tax on Estates and Trusts

A. Health Care and Education Reconciliation Act of 2010, P.L. 111-152. The year 2013 brought a new income tax to estates and trusts. The Health Care and Education Reconciliation Act of 2010 ("HCA 2010") imposes an additional 3.8% income tax on individuals, trusts, and estates. Although the tax is similar between individuals on the one hand and trusts and estates on the other, there are some differences.

B. IRC § 1411. The new income tax is found in new Chapter 2A of the Internal Revenue Code entitled "Unearned Income Medicare Contribution." Chapter 2A is comprised only of Section 1411. Although commonly referred to as a Medicare tax (which is understandable based on the name of the Chapter), the funds will not be placed in the Medicare Fund but will go to the General Fund of the Treasury.

For individuals, the 3.8% 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 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 ($11,950 for 2013 and $12,150 for 2014). For ease of reference, for individuals who are married filing jointly, the threshold is $250,000 (for married filing separately, $125,000 each) and for single individuals, the filing threshold is $200,000. Because the threshold for trusts and estates is based on the highest income tax bracket for each, the threshold is indexed each year to some extent for these entities, whereas there is no indexing for individuals.

The statute as it applies to estates and trusts is as follows:

§ 1411(a) In general. Except as provided in (e) –

(2) Application to estates and trusts. In the case of an estate or trust, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax of 3.8 percent of the lesser of –

(A) the undistributed net investment income for such taxable year, or

(B) the excess (if any) of –

(i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over

(ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

C. Regulations.

1. Proposed Regulations. On December 5, 2012, the IRS issued a Notice of Proposed Rulemaking ("Notice") seeking comments to proposed Treasury regulations related to Section 1411 (77 FR 72611). As stated in the Notice, the purpose of Section 1411 is to impose a tax on "unearned income or investments." The Notice provides that for the most part, the principles of chapter 1 of subtitle A of the Internal Revenue Code are to be applied in determining the tax to be imposed. In addition, the statute introduces terms that are not defined and makes cross references to various other sections of the Internal Revenue Code; however, as pointed out in the Notice, nothing in the legislative history indicates that a term used in the statute is meant to have the same meaning as it would for other income tax purposes. The proposed regulations are intended to provide additional definitions of terms and guidance for the imposition of the tax. The proposed regulations are "designed to promote the fair administration of section 1411 while preventing circumvention of the purposes of the statute."

2. Final Regulations. On December 2, 2013, the IRS and Treasury Department issued final regulations under Section 1411 ("Final Regulations"). For the most part, the Final Regulations are effective for tax years beginning after December 31, 2013. Section 1.1411-3(d)(3), which applies to charitable remainder trusts, is effective for tax years beginning after December 31, 2012. Interestingly, amendments to the Final Regulations should be issued at some point. Contemporaneously with the Final Regulations, the IRS and Treasury Department issued a new set of proposed regulations (78 FR 72451) to further study specific items under Section 1411.

D. Net Investment Income vs. Undistributed Net Investment Income. Individuals, trusts, and estates now have to calculate their "net investment income." Net investment income consists of the sum of three categories of income. IRC § 1411(c)(1). Keep in mind that in each of the three categories of income, when the term "trade or business" is used, it is in reference to that term as defined in Section 1411(c)(2) and as further defined in Treasury Regulation Section 1.1411-4(b).

The first category of income includes gross income from interest, dividends, annuities, royalties, and rents, other than those that are derived in the ordinary course of a trade or business. Note that each of these types of income may be included in the first category even though they may be earned through an activity that may otherwise be thought of as a trade or business. In order to be excluded from this category, the income must meet the ordinary course of a trade or business exception as set out in Treasury Regulation Section 1.1411-4(b). To meet the exception, the trade or business must be one to which the tax will not apply. The second category of income includes other gross income derived from a trade or business. The third category of income includes net gain from the disposition of property held in a trade or business. From the total of these three categories, deductions that are properly allocable are taken. IRC § 1411(c)(1)(B). Exhibit A sets forth a preliminary attempt to diagram the calculation of net investment income.

For estates and trusts, the first component of income taken into account is "undistributed" net investment income, a term that is unique to Section 1411. Although the statute does not define what is meant by "undistributed," the proposed regulations apply rules similar to those in Sections 651 and 661 regarding the carry out of distributable net income ("DNI") to beneficiaries. Treas. Reg. § 1.1411-3(e).

Whereas for other income, DNI carries out to beneficiaries to the extent of a trust or estate's taxable income, for purposes of Section 1411, net investment income will carry out to beneficiaries (and the trust will receive a deduction) in an amount equal to the *lesser of* the trust's DNI or its net investment income. In other words, if a trust has both net investment income and other income, distributions will carry out each class of income pro rata to the beneficiaries. In turn, each beneficiary will pick up the respective classes of income for purposes of computing their income, including net investment income, and the trust will receive corresponding deductions. With the vast difference between the threshold for estates and trusts and individuals, the distribution of net investment income will frequently impact the overall amount of the tax paid.

The interrelation between taxable income, fiduciary accounting income, and DNI can be difficult to understand. When determining a trust's DNI, any amounts that the fiduciary allocates to principal or income for purposes of fiduciary accounting income are irrelevant. Rather, when determining a trust's DNI, the *taxable* income of the trust is what is important. DNI not only determines how much taxable income will be income taxed to a beneficiary, it also determines the amount that will be taxed to a trust or a beneficiary for purposes of Section 1411. Therefore, it is important that these concepts be understood.[4]

E. Trade or Business. The phrase "trade or business" is part of each of the categories of net investment income. Therefore, a fiduciary must evaluate this phrase to determine whether items of income or gain constitute net investment income. Although Treasury Regulation Section 1.1411-1(d)(12) clarifies that a trade or business is one that is defined in

[4] The examples in Proposed Treasury Regulation Section 1.1411-3(f) proposed to illustrate the calculation of undistributed net investment income, but Examples 1 and 2 contained a fundamental mistake in excluding a distribution from an individual retirement account when calculating DNI. The calculations were corrected in the Final Regulations. *See* Treas. Reg. § 1.1411-3(e)(5), Exs. 1 and 2.

Section 162, the term is subject to further limitations of Section 1411. Section 1411(c)(2) limits the application of the tax to a trade or business that is (i) a passive activity or (ii) a trade or business of trading in financial instruments or commodities. IRC § 1411(c)(2); Treas. Reg. § 1.1411-5.. Note that trading in financial instruments or commodities is included regardless of whether or not it is a passive activity. Because income from passive activities comprise the largest portion of what constitutes net investment income, determining what activities are passive is key.

F. Trusts. Although the statute indicates that the tax applies to "trusts," it does not specify which trusts are included. Treasury Regulation Section 1.1411-3(a)(1)(i) specifies that the statute applies to trusts that are subject to part I of subchapter J of chapter 1 of subtitle A of the Internal Revenue Code unless otherwise exempted – in other words, the statute applies to ordinary trusts as defined in Treasury Regulation Section 301.7701-4(a), but not to certain other trusts, including charitable trusts, grantor trusts, foreign trusts, and business trusts. *See* Treas. Reg. § 1.1411-3(b). Certain charitable estates and foreign estates were also included in the exceptions from the tax pursuant to the Final Regulations. Treas. Reg. §§ 1.1411-3((b)(i), (ix). In addition, because subtitle A does not include tax exempt trusts, the statute does not apply to tax exempt trusts. After receiving comments to the proposed regulations, the Final Regulations also provide that the tax does not apply to certain Alaska Native Settlement Trusts and Cemetery Perpetual Care Funds. Treas. Reg. §§ 1.1411-3((b)(vi), (vii).

G. Grantor Trusts. The grantor trust rules for income tax purposes are to be applied for purposes of Section 1411. Therefore, the 3.8% tax is not imposed on a grantor trust, but items of income or deductions that are attributable to the grantor (or to someone treated as the grantor) are to be treated as if the items had been paid or received by the grantor for calculating his or her own net investment income. Treas. Reg. § 1.1411-3(b)(1)(v).

H. Special Problem Areas. Although the statute uses terms such as "net investment income," "adjusted gross income," "ordinary course of a trade or business," "passive activity" and "disposition," the terms do not necessarily correspond to the same terms as used in other parts of the Internal Revenue Code. Following is a discussion of some net investment income problem areas, but this is in no way meant to be an exhaustive list.

1. Capital Gains. A review of the statute and proposed regulations raises a concern for existing trusts and estates with regard to the treatment of capital gains. As mentioned above, trust and estate income is taxed to the trust or estate unless the income (or more specifically unless the trust's or estate's DNI) is carried out to the beneficiaries. As a general rule, capital gains are not treated as part of DNI. This general rule applies as long as those gains are allocated to corpus and are not "paid, credited, or required to be distributed to any beneficiary during the taxable year." IRC § 643(a)(3). However, pursuant to Section 643 and the related Treasury regulations, capital gains may be included in DNI under certain conditions and if done pursuant to local law, the trust agreement, or "a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)." Treas. Reg. § 1.643(a)-3(b).

Two of the three conditions which allow a fiduciary to allocate capital gains to DNI can invoke a consistency requirement by the fiduciary for all future years. *Id*. Most commentators and practitioners believe that in the first year that a trust or estate incurs capital gains, once a fiduciary decides to allocate the capital gains to DNI or not to do so, the fiduciary has in effect made an election that remains in place for all future years of the trust or estate. Unfortunately, there is no authority or guidance in this area to suggest otherwise. A trust or an estate may have the ability to allocate capital gains to corpus on a case-by-case basis under a narrow condition provided by Treasury Regulation Section 1.643(a)-3(b)(3), but there is no clear guidance for fiduciaries as to how to meet the condition under this so-called "deeming rule." Since many capital gains are included in net investment income under Section 1411, trusts and estates that do not include capital gains in DNI (which are most trusts and estates), or cannot "deem" capital gains to be part of DNI under the narrow condition provided in the regulations, will have this component of net investment income trapped as undistributed net investment income, taxable to the trust or estate. Section 1411 does not (and the related proposed Treasury regulations did not) address this issue for existing trusts or estates, although for other similar elections, an entity is given a fresh start to make a new election. The IRS and Treasury received comments requesting that existing trusts and estates that incur capital gains after December 31, 2012 be given the option to reconsider how capital gains are to be allocated. The Final Regulations, however, did not adopt the request, reasoning that a fiduciary's decision in this regard is similar to other elections "that only indirectly impact the computation of net investment income" and that potential changes in the capital gains rate is something foreseeable to a fiduciary when making the election. *See* Final Regulations, Summary of Comments and Explanation of Provisions, § 4.E.

2. Passive Activities, Passive Income, and the Passive Loss Rules. The statute does not define to what extent the passive loss rules for "ordinary" income taxes will apply. For purposes of Section 1411, however, passive activities are those that are included within the meaning of Section 469. IRC § 1411(c)(2)(A). To determine if an activity is a passive activity, a two-step determination is needed. First, the activity must be a trade or business within Section 162. Second, the activity must be passive within the meaning of Section 469, which means the taxpayer must not materially participate in the trade or business. Treas. Reg. §§ 1.1411-1(d)(12), 1.1411-5(b). Section 469 further provides that in order for a taxpayer to materially participate in an activity, the taxpayer must be involved in the operations of the activity on a *regular, continuous and substantial* basis. IRC § 469(h)(1). It appears that for the most part, the majority of passive income will be included in the calculation of the tax under Section 1411. However, there are certain exceptions where items that are generally thought of as passive are not included and vice versa, such as in the case of actively managed real estate investments. As a result, practitioners will need to not only have a good understanding of Section 469 and its related Treasury regulations to know what constitutes a passive activity but will also need to master the exceptions under Section 1411 when computing net investment income.

a) Material Participation. Because Section 1411 defers to Section 469 to define a passive activity, we must look to Section 469. For determining the disallowance of passive activity losses and credits, Section 469 applies to individuals, trusts[5], estates, closely held C corporations, and personal service corporations. IRC § 469(a). Although Section 469 applies to trusts and estates, what amounts to material participation by a trust or estate has not been defined beyond the requirement that the taxpayer's involvement in the operations of the business must be regular, continuous and substantial. The temporary regulations outline seven separate tests that an individual may satisfy in order to meet the definition of material participation and avoid the passive loss disallowance rules. Since the statute was enacted in 1986, however, no such regulations have been issued for trusts and estates. Temp. Treas. Reg. § 1.469-5T(a), 1.469-5T(g), 1.469-8.

From Section 469 we can glean that the taxpayer's involvement in the operations is what is important. However, for trusts and estates, who the taxpayer is continues to be an issue. Only one federal case has addressed this issue. In *Mattie K. Carter Trust v. U.S.*, 256 F.Supp.2d 536 (N.D. Tex. 2003), a testamentary trust owned a cattle ranching operation. In addition to work done by the trustee himself, the trust employed a ranch manager and other employees. The work done by the trustee, the ranch manager, and the other employees was performed on behalf of the trust. The IRS argued that the trustee is the taxpayer and only his activities should be considered to determine whether the trustee materially participated in the operations. The trust argued that the trust, as a legal entity, is the taxpayer and the activities of the fiduciaries, employees and agents of the trust should be considered. The court looked to the plain language of Section 469 which states that a trust is the taxpayer, and in agreeing with the trust, held that the material participation of the trust should be determined by looking at the activities of all persons acting on behalf of the trust, not solely the trustee. The court noted that common sense says that in order to determine material participation by a trust, one must look to the activities of all of those who work on behalf of the trust.[6]

In the decade since the holding in the *Mattie K. Carter Trust* case, and with no regulations having being issued, the IRS has continued to maintain its position that only the activities of the trustee should be considered. *See*, PLR 201029014; TAM 201317010; TAM 200733023. The only source that the IRS cites for its position is language in the legislative history of Section 469 that states that "an estate or trust is treated as materially participating in an activity . . . if an executor or fiduciary, in his capacity as such, is so participating." S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986). It is important to note, however, that nothing in the legislative history indicates that looking to the actions of an executor or trustee is the exclusive way to determine material participation by a trust or an estate. In the most recent Technical Advice Memorandum, the IRS again found that the language in the legislative history is the standard to apply to trusts for determining material participation. In so finding, the IRS inexplicably comes to the conclusion that the *sole* means for making such determination is to find that in the operation of the activity, the activities of fiduciaries, in their capacities as fiduciaries, are

[5] Like with Section 469, the trusts at issue are non grantor trusts because the passive activity loss rules do not apply to grantor trusts and instead are applied at the grantor level. Temp. Treas. Reg. § 1.469-1T(b)(2).

[6] In criticizing the IRS, the court went as far as to say that the IRS's position that only the activities of the trustee himself should be considered is "arbitrary, subverts common sense, and attempts to create an ambiguity where there is none." *Id*. Zowie!

conducted on a regular, continuous, and substantial basis. TAM 201317010.

In relying on limited language in legislative history for its reasoning in these decisions, the IRS appears to ignore the ability to consider activities of employees when determining material participation by other categories of taxpayers in Section 469. *See*, Temp. Treas. Reg. § 1.469-1T(g) (allowing activities of employees of corporation to be taken into account by virtue of the rules of Section 465(c)(7)) and Temp. Treas. Reg. § 1.469-5T(k) (Examples 1 and 2 where activity as employee by owner of entity counts toward whether entity materially participates in a business). Although it may be understandable to disregard the activities of employees of the underlying operation who are not trustees, employees of the trust itself are not the same, and their activities should be taken into account. Unless and until the IRS reverses its narrow view of these rules, commentators suggest for trusts that own an interest in an entity such as a limited liability company, the entity might be structured to be member-managed so that the activities of the trustee (owner) count toward material participation. Of course, in this case, the trustee would owe fiduciary obligations to the company as well as to the trust beneficiaries and would need to explore how best to deal with any potential division of loyalties in exercising its fiduciary duties. For other thoughts and potential planning alternatives when a trust owns an interest in a business entity, see Gorin, *Structuring Ownership of Privately-Owned Business: Tax and Estate Planning Implications* (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").

One case currently before the Tax Court involves an issue of whether a trustee qualifies for a certain exception under Section 469 for real estate activities. *Frank Aragona Trust v. Comm'r.*, Tax Court Docket No. 015392-11. Because this exception involves a determination of material participation by a taxpayer, the court's ruling may have an impact on a trustee's material participation for other purposes of Section 469. The case was tried before the judge in May 2012 and briefs were submitted in October 2012. Hopefully we will receive some guidance in the near future.

Section 1411 and the Final Regulations require taxpayers to look to Section 469 for the passive activity loss rules. It seems evident that the IRS and Treasury Department did not want to add anything new to the passive activity loss rules through Section 1411. With no regulations being issued for Section 469 to deal with passive activities and material participation for trust and estates, as expected the Final Regulations declined to address the issue and practitioners continue to struggle with what guidance to give their clients. Although recognizing that commentators to the proposed regulations raised valid concerns regarding this issue, the IRS and Treasury Department deferred to Section 469 and a separate study of the issue being conducted from which separate guidance may come. Comments were welcomed for consideration and several groups have indicated plans to respond. *See* Final Regulations, Summary of Comments and Explanation of Provisions, § 4.F.

3. Qualified Subchapter S Trusts ("QSSTs"). In most cases, when a trust owns stock in an S corporation and the income beneficiary makes an election to have the trust treated as a QSST, because the beneficiary is treated as the owner of the stock for income tax purposes, all income from the S corporation which is attributable to the QSST will be taxed to the beneficiary.[7] Treas. Reg. § 1.1361-1(j)(7). An exception to this rule is when a disposition of the S stock occurs. In that case, the beneficiary is not treated as the owner and any resulting gain or loss that is recognized will be reported by the trust. Treas. Reg. § 1.1361-1(j)(8). For Section 1411 purposes, neither the statute nor the original proposed regulations provide any special rules that would change these results. Rather than issuing final regulations regarding QSSTs, the IRS and Treasury Department issued a new set of proposed regulations at the same time as the Final Regulations. Under the new proposed regulations, these same rules will apply with regard to allocating income and gain for QSSTs. As a result, a QSST's share of an S corporation's net investment income will be taxed to the beneficiary, but net investment income arising from a sale of S corporation stock will be taxed to the trust. Prop. Treas. Reg. § 1.1411-7(a)(4)(iii)(C). Moreover, the passive nature of any gains or loss on the disposition will be determined at the trust level, and will not be based on the material participation of the beneficiary. *Id*. In determining the amount of net investment income that results from a sale of S corporation stock, the new proposed regulations set out complex rules for entities that have activities that are passive only in part as to the transferor. *See*, Prop. Treas. Reg. §§ 1.1411-7(b)-(c).

As a reminder, income for trust and estate purposes is not always the same as income for income tax purposes. Section 643(b) provides that for trusts and estates, if the general term "income" is used, it means fiduciary accounting income as determined pursuant to

[7] Remember that because a QSST is treated as a grantor trust that is deemed to be owned by the beneficiary, the character of income is determined and the test for material participation occurs at the deemed owner level instead of at the trust level.

the governing instrument and local law, and *not* taxable income. IRC § 643(b). Because a beneficiary will have to report taxable income as part of DNI but will receive only a distribution of fiduciary accounting income (if any), the distinction between fiduciary accounting income and taxable income is important when considering a QSST election. Accordingly, it raises the question as to whether a beneficiary should try to obtain some assurance or guarantee from the trustee regarding sufficient cash distributions, whether of income or principal, in order to pay any income tax liability that arises from the QSST election. For additional discussion regarding the income characterization issues, see Davis, *Funding Testamentary Trusts: Tax and Non-Tax Issues*, State Bar of Texas Adv. Est. Pl. Strat. Course (2013).

4. Electing Small Business Trusts ("ESBTs"). In contrast to a QSST, when a trust holds S corporation stock and the trustee makes an election to have the trust treated as an ESBT, all income from the S corporation is taxed to the trust at the highest income tax bracket, regardless of whether any income is distributed to a beneficiary and without regard to any threshold. IRC § 641(c). The portion of the trust that holds the S corporation stock is treated as if it were a separate trust. *Id*. If all or any portion of an ESBT is a grantor trust, the income attributable to such portion is taxable to the grantor. Treas. Reg. § 1.641(c)-1(c). As with other S corporation shareholders, in making an ESBT election, a trustee would want some assurance from the S corporation that sufficient cash distributions will be made from the corporation to allow the trustee to pay any income tax liability. An ESBT will have to pay income tax on its share of S corporation income at the highest marginal rate. The trustee of an ESBT, therefore, must make careful consideration before making any distributions to beneficiaries, since the trust will need to retain sufficient funds to pay any income tax liability and will not have the advantage of reducing the trust's taxable income since it will not receive a distribution deduction for these distributions.

Also in contrast to QSSTs, Section 1411 provides special rules for ESBTs. In Treasury Regulation Section 1.1411-3(c), two separate computations are made to determine whether income of an ESBT is subject to the net investment income tax. In line with the stated attempt to preserve as much Chapter 1 treatment as possible, the first calculation requires that the amount of the undistributed net investment income be calculated for each of the separate S and non S portions of the trust. The separate treatment is disregarded, however, for the second calculation because the Final Regulations require the ESBT to then calculate its adjusted gross income by combining the adjusted gross income of the non S portion of the trust with the net income or net loss of the S portion of the trust. *Id*. In other words, the trust is treated as a single trust for determining whether the trust's adjusted gross income exceeds the Section 1411 threshold. The trust is then to pay tax on the lesser of the trust's total undistributed net investment income or the excess of the trust's adjusted gross income over the trust's threshold. Treas. Reg. § 1.1411-3(c)(2)(iii). Treasury Regulation Section 1.1411-3(c)(3) provides a detailed example of the calculation. Again, as discussed above, these calculations can be avoided if the trustee's involvement in the S corporation constitutes material participation which would prevent treatment as a passive activity and imposition of the net investment income tax.

5. Charitable Remainder Trusts. Although charitable remainder trusts are not themselves subject to Section 1411, distributions that are made to non-charitable beneficiaries may be. The first set of proposed regulations provided what was termed by the IRS and Treasury Department to be a simplified method of reporting for charitable remainder trusts. After receiving comments requesting that net investment income of a charitable remainder trust be treated as a subset of the income earned by the trust, the Final Regulations adopted this approach. Therefore, for a charitable remainder trust, net investment income is assigned to the related tier or class of income set forth in Section 664 of the Code and is distributed to a beneficiary as that class of income is distributed. Treas. Reg. § 1.1411-3(d). The Final Regulations require that the trustee keep track of accumulated net investment income (i.e., net investment income accrued but not distributed after December 31, 2012). Treas. Reg. § 1.1411-3(d)(1)(iii). Any non-accumulated net investment income is also to be tracked but will be treated as excluded income for purposes of Section 1411 of the Code. Treas. Reg. § 1.1411-3(d)(2). In issuing the new set of proposed regulations, the IRS and Treasury Department requested comments as to whether the alternate simplified approach should be retained and a section of the Final Regulations was reserved for this purpose, just in case. Pursuant to the alternative method, the net investment income of a non-charitable beneficiary would include an amount equal to the lesser of the distributions made for the year or the trust's current and accumulated net investment income. Prop. Treas. Reg. § 1.1411-3(d)(2)(ii). In addition, certain character and ordering rules would be imposed in order to first distribute net investment income proportionately among the non-charitable beneficiaries before any amounts of non-net investment income. *Id*. For many non-charitable beneficiaries of charitable remainder trusts, the alternative method appears to be a WIFO ("worst in – first out") approach, thereby imposing another layer of tax on these beneficiaries. However, for some charitable remainder trusts, such as those that never accumulate net investment income, the simplified approach may be preferred. Availability of the simplified approach will not be known until the IRS and Treasury Department review requested comments and determines whether to amend the Final Regulations.

6. Allowable Losses and Properly Allocable Deductions. The only deductions allowed in computing net investment income are those that are allowed by subtitle A of Chapter 1 of the Internal Revenue Code and that are properly allocated to the gross income or net gain that is part of net investment income. IRC § 1411(c)(1)(B). The key is that the deductions must be allocable to the related gross income or net gain. In addition, in general, allowable losses may not exceed net gain such that net gain will be less than zero.[8] Treas. Reg. § 1.1411-4(d)(2). Treasury Regulation Section 1.1411-4 places further limitations on the amount and timing of deductions. In the Notice, the IRS asked for comments regarding the treatment of certain deductions, such as suspended passive losses and net operating losses.

Of particular note, the Final Regulations specify deductions that are considered property allocable. Some of these deductions are: a deduction for unrecovered basis in an annuity in a decedent's final year; a deduction to beneficiaries of a trust or estate for any net operating losses, capital loss carryovers, and other excess deductions passing to them in the final year of the trust or estate as provided in Section 642(h) of the Code; deductions in respect of a decedent as provided in Section 691(b) of the Code; a deduction for estate taxes paid on IRD items as provided in Section 691(c) of the Code; and a deduction for ordinary and necessary expenses related to the determination, refund, or collection of tax, to be allocated to net investment income using any reasonable method. Treas. Reg. §§ 1.1411-4(f)(3)(iv), (f)(3) (v), (f)(3) (vi), (g)(3), (g)(4). If an IRD item is an ordinary income item, the deduction for the related estate tax pursuant to Section 691(c) of the Code is treated as an itemized deduction not subject to the 2% floor, whereas if the IRD item is a capital gain, the deduction is used in calculating net gain. Treas. Reg. §§ 1.1411-4(f)(3)(v), (7).

I. Special Notes. A few additional items of note:

1. Tax Does Not Apply to Distributions from Qualified Plans. You will recall that there are two components of income used to measure whether the tax will apply. One type of income is net investment income and the other is adjusted gross income (modified adjusted gross income for individuals and adjusted gross income as defined in Section 67(e) of the Code for trusts and estates). Section 1411(c)(5) provides that net investment income does not include distributions from qualified plans. However, there is no exception for distributions from qualified plans for purposes of computing adjusted gross income. As a result, distributions from qualified plans may push the trust or estate into the top income tax bracket, exposing its net investment income to the 3.8% tax.

2. Nonresident Aliens. The tax does not apply to nonresident aliens. IRC § 1411(e)(1).

J. Planning for the Tax. The additional 3.8% income tax on trusts and estates can be considered an additional cost of forming a trust or administering an estate. Items to consider include:

- Planners will need to advise clients that certain investments may subject estates and trusts to additional income tax. For example, when funding testamentary trusts, it may be more desirable to transfer the homestead to the surviving spouse and make a non pro rata distribution of other assets to fund the trust so that if the homestead is later sold, any appreciation will not be subject to the tax imposed under Section 1411.
- There may be even more reason for clients to take a team approach with the attorney, accountant and financial planner to adequately plan to minimize the additional tax burden.
- Fiduciaries have a greater burden with the additional recordkeeping necessary to track assets that may be subject to the 3.8% tax, and most likely will need even more assistance than before from accountants.
- When evaluating whether to make a distribution, fiduciaries may desire additional cooperation between themselves and beneficiaries in order to better evaluate the tax brackets of each as they relate not only to income taxes, but also the tax on net investment income.
- There may be more incentive to speed up the administration of estates to minimize the potential

[8] An exception to this general rule is found in Treasury Regulation Section 1.1411-4(f)(4). If a loss is described in Section 165 of the Code, any excess loss may be deducted against unrelated net investment income if it is not used in computing net gain under Section 1.1411-4(d). In other words, a loss will first offset a related net gain down to zero, and if any excess loss remains, the loss can offset any unrelated net investment income.

of the additional tax that may not apply once the assets which produce net investment income are transferred to beneficiaries.

- Fiduciaries will need to weigh whether it is better to invest more in assets that are not subject to the tax, such as those that produce tax-exempt income vs. those assets that may produce a higher after-tax return regardless of this additional tax.
- There may be more incentive to take a buy-and-hold approach to investing in order to put off the additional tax burden that may arise from recognizing capital gains.

IV. WHAT WORKS NOW?

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

A. Intra-Family Loans. One of the most attractive wealth-transfer strategies is also one of the simplest–a family loan.[9] The IRS permits relatives to lend money to one another at the "Applicable Federal Rate," which the IRS sets monthly. Even with good credit, it has become increasingly frustrating for people to qualify for bank loans. With an intra-family loan, relatives can charge far less than a bank. For example, in April, 2014, when Bankrate.com quoted the rate on a 30-year mortgage at around 4.50%, the Applicable Federal Rate ranged from 0.28% to 3.32%, depending on the loan's term.

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

Example: In April, 2014, Mom loans $400,000 to her daughter and son-in-law to purchase a home. Mom structures the loan with a thirty year amortization, but with a balloon payment due at the end of nine years. Because the couple was able to lock in an interest rate of just 1.81% over the next nine years instead of the 4.50% offered by their bank, the couple will save over $10,700 in interest costs the first year alone, while reducing their monthly payments by $586 from $2,027 to $1,441. The young couple will profit as long as the home appreciates by more than the modest cost of interest. To further reduce the cost of the loan, and put even more potential profits in her kids' pockets, Mom might use another estate-planning technique. She and her husband can use the $14,000 each is able to give tax-free to their daughter and son-in-law every year to pay down the loan's principal. (See "Outright Gifting," below). By reducing the size of the loan, this tactic would slash the total amount of interest the young couple will owe on this debt. By helping the couple retire its $400,000 debt to her, Mom will also reduce her estate by as much as $400,000 – that could cut her estate tax bill by $160,000.

Specifics. Family loans are governed by Code Section 7872. This section of the Code generally deals with interest-free or "below-market" loans between related taxpayers—not the type of loan described above. For family loans, Section 7872 provides that a below-market loan will be treated as a gift loan, resulting in the imputation of a gift from the lender to the borrower in an amount equal to the foregone interest. In addition, a below-market loan results in a deemed payment of interest by the borrower to the lender for income tax purposes. Section 7872 not only spells out the consequences of a "below-market" loan, but also requires the IRS to set the "market" rate for loans each month. With IRS interest rates at historically low levels, there is no need for families to make "below-market" loans. A loan at the market rate set by the IRS works just fine.

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

2. Demand Loans. A demand loan will not be treated as a gift loan, provided that the interest rate applicable to the demand loan is at least equal to the short-term Applicable Federal Rate for the period in

[9] For a thorough discussion of this subject, see Akers and Hayes, *Estate Planning with Intra-Family Loans and Notes*, State Bar of Texas 36th Annual Est. Pl. & Prob. Course (2012).

which the loan is outstanding, compounded semi-annually. IRC § 7872(f)(2).

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

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

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

6. Death During Term. If the lender dies during the term of the loan, any unpaid balance will generally be included in the taxable estate of the lender. Note, however, that the value of the note is generally limited to the value of the collateral and the net worth of the borrower, without regard to any amount the borrower might inherit. *See Est. of Elizabeth V. Harper*, 11 TC 717 (1948), *acq*., 1949-1 CB 2; TAM 9240003 ($215,000 note owed to estate of uncle by insolvent nephew properly valued at substantially less than face value despite testamentary forgiveness of debt and $1 million bequest to nephew from uncle); Treas. Reg. § 20.2031-4. If the junior family member has paid back any portion of the loan, the repaid funds will likewise be included in the lender's estate. It is the income in excess of the IRS interest rate that the junior family member earns by investing the principal of the loan that escapes estate taxation. Of course, as discussed above, the senior family members may use their gift tax annual exclusion to reduce the outstanding principal balance, thereby reducing estate inclusion at the time of their deaths, as long as there is no pre-arranged plan to do so.

7. Use with Grantor Trusts. To ameliorate the impact of income taxes, instead of a loan from senior family members to junior family members, senior family members could create an "intentionally defective" grantor trust or "IDGT" for the benefit of junior family members and make a loan to the grantor trust.

a) Borrower's Credit-Worthiness. If a senior family member wants to loan money to a grantor trust, the grantor trust should be "seeded" with sufficient assets to make the trust a credit-worthy borrower (most commentators suggest a 10% seed money gift). Without this equity, the IRS might doubt the trust's ability to repay the loan, especially if the trustee invests the loan proceeds in illiquid or volatile investments. If the loan can't be repaid, the IRS might instead treat it as a gift.

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

8. Rates and Yield Curves. Although short-term interest rates are normally lower than the mid-term and long-term rates, there are times when the mid-term interest rates and the long-term interest rates are less than the short-term interest rates. Furthermore, there are periods of time where the spread between short-term rates and long-term rates is minimal. As a result, it can be advantageous to try to time the loans to coincide with favorable interest rates. The IRS generally publishes rates for the following month about ten days in advance. So, for example, the IRS published the April, 2014 rates on March 19th. Therefore, near the end of a month, planners can preview upcoming rates to time a transaction to take advantage of the most favorable rates.

9. Current Rates. The current annual interest rates (for April, 2014) are as follows:

(1) Short-term annual interest rate – 0.28%

(2) Mid-term annual interest rate – 1.81%

(3) Long-term annual interest rate – 3.32%

Rev. Rul. 2014-8, 2014-15 IRB ___.

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

11. Payment at Maturity. Upon maturity, junior family members can either repay the loan or renegotiate the terms of the note. If interest rates decline during the term of the note, or if they are lower at maturity, it may be possible to renegotiate at a time when interest rates are favorable. To allow for this option, the promissory note should contain a provision which allows the outstanding principal balance to be repaid at any time without any penalty. *See* Blattmachr et al., *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. OF TAX'N 22 (2008). Some commentators caution, however, that the loan should not be renegotiated too frequently, since doing so may appear to be gratuitous rather than part of a business transaction.

B. Sale to an Intentionally Defective Grantor Trust. Although a popular trust strategy, a sale of an asset to an IDGT, can be somewhat complex to explain and expensive to set up. Why bother? For one thing, the payoff is potentially greater than with many other strategies. In addition, a sale to an IDGT can provide a tax-advantaged way to pass assets to children and grandchildren while keeping the value of the trust's assets out of the estates of junior family members, as well as keeping growth of the assets that were sold out of the estates of senior family members.

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

Example: Clint has established a family limited partnership that holds $12.5 million in cash and securities. Clint has recently had his interest appraised at $10 million (a 20% discount). In April, 2014, Clint establishes an IDGT for the benefit of his children. To buy the limited partnership interest from Clint, the IDGT will need some cash, so Clint gives the trust $1 million. Because Clint wants this trust to endure for generations, he will use some of his $5.34 million GST exemption to shelter the trust from the GST tax. With $1 million in cash, plus a $9 million loan from Clint, the trust will buy Clint's limited partnership interest valued at $10 million. The 20-year note from the IDGT to Clint bears interest at the Applicable Federal Rate, which for loans of more than 9 years, was 3.32% in April, 2014.

Of course, the goal is for the trust's assets to earn enough to cover the loan, while leaving something more for Clint's children and grandchildren. Based on past performance, Clint expects the partnership's investments to appreciate at least 8% a year–that would be more than enough to make the 3.32% interest payments. Over the next 20 years at 8%, Clint can expect that the $12,500,000 in assets owned by the partnership will grow to around $44.5 million, even after paying out $298,800 per year to cover the interest on the note, assuming an interest-only note with a balloon payment at the end of the term. At the end of the 20-year term, the trust will repay Clint his $9 million. After repaying the note, the trust will hold over $35.5 million, which will be available to Clint's children and grandchildren without having paid any gift or estate tax.

Because IDGTs are grantor trusts, Clint won't owe any income tax on the gains he realizes by selling his limited partnership interest to the trust, nor will he have to pay income tax on the interest payments he receives. As far as the IRS is concerned, it's as if Clint sold the asset to himself. Clint will, however, owe income tax on the partnership's earnings. In this example, though, the interest paid to Clint will more than offset his tax liability so long as the effective tax rate (earned through a combination of dividends, capital gains, and other income) is less than 33.5% or so. There are plenty of caveats. Neither the Code nor case law specifically addresses IDGTs, and the IRS has been known to challenge them on occasion. In fact, in two companion cases filed in Tax Court in December, 2013 but not yet decided by the Court, the IRS alleges that the notes received by the taxpayers when assets were sold by them to an IDGT were not notes at all, and, applying the special valuation rules of Chapter 14 of the Code, valued the amounts received by the taxpayers at $0, meaning that the entire value of the property transferred was treated as a gift. Then, applying different rules, the IRS asserts that the transferred assets are includable in the taxpayer-husband's estate for federal estate tax purposes. *See Esate of Donald Woelbing v. Comm'r* (Docket No. 30261-1); *Estate of Marion Woelbing v. Comm'r* (Docket No. 30260-13). In addition to IRS challenges, the Obama administration's budget proposals for the past three fiscal years have included a recommendation that legislation be enacted to eliminate the tax benefits of sales to IDGTs.[10] Aside from the tax risk, there is also the financial risk that the trust may simply go bust. If its assets decline in value, the IDGT will have to come up with the cash to pay Clint. If Clint took back a security interest in the property that was sold, he could seek foreclosure on the property. Also, the IDGT can always use the money Clint gave it–the $1 million–to repay him. If that happens, Clint won't be able to reclaim the $1 million gift and GST tax exemptions he used when the trust was created. These exemptions will have been wasted.

Specifics.

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

[10] *See* U.S. Treasury, "General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals," (March, 2014) (commonly called the "Greenbook"), which can be found at www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf.

the sale is ignored for federal income tax purposes. *See* Rev. Rul. 85-13, 1985-1 CB 184.

2. Seeding of Trust. The IRS has offered no official guidance, but most practitioners recommend that the trust have "equity" of about 10% of the purchase price. In most cases, clients provide this "seed" money by making a taxable gift of cash or assets to the trust, typically sheltering the gift from tax by using some of their unified credit. A gift tax return is filed, reporting both the seed gift and the sale, thereby starting the gift tax statute of limitations running on the values used in the sale. Some clients can use an existing grantor trust which already has sufficient assets to provide the seed money. Sometimes it may be impractical for a trust to be seeded with the appropriate level of assets (i.e., the senior family member is unwilling to incur a sizable taxable gift). Instead of (or in addition to partially) seeding the IDGT, the beneficiaries could personally guarantee the promissory note. However, the beneficiaries should independently have sufficient net worth to cover the amount of the guarantee. There is an element of risk with the guarantee approach because the IRS might take the position that the guarantee constitutes a gift from the beneficiary to the grantor trust. One way to reduce this risk is to have the trust pay the guarantor(s) a reasonable fee for the guarantee. *See* Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152 (Mar. 2000).

3. Impact of Interest Rates. When interest rates are low, sales to IDGTs become very attractive, since any income or growth in the asset "sold" is more likely to outperform the relatively low hurdle rate set by the IRS for the note.

4. Servicing the Debt. With regard to servicing the interest payments on the promissory note, the sale to the IDGT works especially well when rental real estate or other high cash-flow investments are sold. If these assets are contributed to a family limited partnership prior to being sold to the IDGT, distributions of partnership rental or investment income to the IDGT can be used to service the note payments. Care should be taken to ensure that payments do not match income; otherwise, the IRS may use this fact in support of application of the step transaction doctrine. *See Pierre v. Comm'r*, TCM 2010-106 (regular distributions made from a limited partnership in order to service debt incurred in order to purchase interests).

5. Grantor Trust Implications. Senior family members must thoroughly understand the notion of a grantor trust. They should understand their obligation to pay tax on the IDGT's income, even if the IDGT does not have cash flow to make interest payments (or if the interest payments are insufficient to service the debt or pay these taxes). In addition, since the transaction is ignored for income tax purposes, no basis adjustment is made at the time of the sale.

6. Death of Note Holder. As with an intra-family loan, if the lender dies during the term of the loan, any unpaid balance will generally be included in the taxable estate of the lender. Again, however, the value of the note is generally limited to the value of the collateral and the net worth of the borrower, without regard to any amount the borrower might inherit. *See Est. of Elizabeth V. Harper*, 11 TC 717 (1948), *acq.*, 1949-1 CB 2; TAM 9240003. If the grantor dies before the note is paid in full, or if grantor trust treatment is otherwise terminated before the note is paid off, there may be adverse income tax consequences, including recognition of gain on the sale, and future recognition of interest income on the note payments. *See Madorin v. Comm'r*, 84 TC 667 (1985); Treas. Reg. § 1.1001-2(c), Example 5; Rev. Rul. 77-402, 1977-2 CB 222; *Cf. Est. of Frane v. Comm'r*, 93-2 USTC ¶ 50,386 (8th Cir. 1993) (gain on SCIN recognized by *estate of payee* upon death of note holder); Peebles, *Death of an IDIT Noteholder*, TR. & ESTS. (August, 2005) at p. 28.

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

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

9. Selling Discounted Assets. Appreciating or leveraged assets are an ideal candidate for sale. As noted in the example above, use of lack-of-marketability and minority interest discounts can provide more bang for the buck. The trust pays interest at favorable rates on the discounted value, while the underlying assets grow at full market rates.

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

C. Grantor Retained Annuity Trusts. With a grantor retained annuity trust, or "GRAT," heirs typically won't receive quite as much as they would with an IDGT. But GRATs, are also less risky, in part because they can be set up to completely avoid any gift tax consequences. Moreover, because the Code sanctions them, there is very little risk of running afoul of the IRS. In fact, GRATs have been so successful that Obama's most recent budget proposal, following similar requests in 2010, 2011 and 2012, has asked Congress to impose some restrictions on the use of GRATs, for example, requiring them to have a term of at least ten years, a remainder interest equal to greater than zero, and prohibit any decrease in the annuity during the GRAT term.[11]

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

Because a successful GRAT is one that appreciates a lot, it's best to select an asset that the client thinks is on the verge of rapid appreciation. The classic example: shares in a privately held company that is likely to go public, or oil and gas interests in which future production is eminent. These days, beaten-down real estate is also a good candidate if it produces positive cash flow. In reality, any asset that the client expects to rise in value more rapidly than the IRS interest rate will work, but the higher the appreciation, the better.

Example: Greta owns all of the stock in her closely held business. Although there is no deal on the table, some potential buyers have expressed an interest in buying the company for $15 million. Nevertheless, a business appraiser values a one-third interest in the company at $3 million (applying traditional lack-of-marketability and minority interest discounts). Greta decides to transfer one-third of her stock to a GRAT, retaining the right to get back the $3 million of value she put into the trust in equal annual installments. Greta will also receive a little extra–an annual interest payment designed to make sure she takes back what the IRS assumes the stock will be worth in 10 years, when the trust expires. To estimate the rate at which investments in a GRAT will grow, the IRS uses the so-called "7520 rate," which is based upon 120% of the monthly mid-term Applicable Federal Rate. When Greta set up her GRAT in April, 2014, the 7520 rate was 2.2%.

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

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

As with IDGTs, GRATS are grantor trusts. As such, they allow the grantor to pay capital-gains and income taxes on the investments in the GRAT on behalf of his or her heirs. Because the IRS doesn't consider such tax payments a gift, they are another way to transfer wealth

[11] *Id.*

to the next generation free of gift and estate taxes. Rev. Rul. 2004-64, 2004-2 CB 7.

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

Specifics.

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

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

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

4. Impact of Interest Rates. The common wisdom is that GRATs work best in times of low interest rates and depressed markets. This notion is based upon the fact that the lower the Section 7520 rate, the lower the annuity payments need to be to zero out the GRAT. As a result, at the end of the annuity term, more assets will be available to pass to the ultimate beneficiaries gift-tax free. Surprisingly, studies have shown that for short-term GRATs, current interest rates have very little impact on the success rate of the GRAT. Instead, GRATs work best when the value of the assets contributed to the GRAT are depressed and rebound in the short term to far exceed their value at the time of contribution. In fact, one study showed that the success of short-term GRATs are impacted only about 1% by the Section 7520 rate, 66% by first-year growth, and 33% by second-year growth. *See* Zeydel, *Planning in a Low Interest Rate Environment: How Do Interest Rates Affect the Calculations in Commonly Used Estate Planning Strategies?* 33 EST., GIFTS & TR. J. 223, 226 (2008).

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

6. Death During GRAT Term. If the senior family member dies during the annuity period, the senior family member's estate will include the *lesser* of (i) the GRAT assets at the date of death; or (ii) the amount necessary to yield the remaining annuity. *See* Treas. Reg. §§ 20.2036-1(c), 20.2039-1(e); T.D. 9414 (7/14/08). Unless interest rates rise dramatically, or the trust's assets appreciate in value very rapidly, the amount necessary to yield the remaining annuity will probably be very close to the entire value of the GRAT. If that is the case, virtually the entire GRAT value gets included in the estate of the deceased senior family member. Since the amount includable is the lesser of the date-of-death value of the trust or the amount need to continue the annuity, it is important to make the latter calculation.

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

8. Benefit to Heirs. At the end of the annuity period, the property remaining in the GRAT (after paying the senior family member the annuity pursuant to the GRAT terms) passes to the ultimate beneficiaries (typically junior family members, either outright or in further trust) with no further gift tax liability. This is the goal of a GRAT, and why highly appreciating assets work best. If the contributed assets grow faster than the GRAT interest rate, the excess growth passes to the GRAT beneficiaries. Remember, the IRS requires that the gift tax consequences be evaluated when the GRAT is created–not when the GRAT term comes to an end.

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

10. Short-term v. Long-term GRATs. As indicated above, the use of short-term (i.e., 2-year) GRATs have typically been more popular than using longer-term GRATs. The reasoning behind the preference for short-term GRATs is twofold. First, using a short-term GRAT reduces exposure to the risk that the senior family member will die during the term, which, as stated above, would cause all or a portion of the value of the GRAT assets to be included in the senior family member's gross estate. Second, a short-term GRAT minimizes the possibility that a year or two of poor performance of the GRAT assets will adversely impact the overall effectiveness of the GRAT. When funding a GRAT with volatile securities, a series of short-term GRATs typically perform better than a single long-term GRAT. Notwithstanding the benefits of short-term GRATs illustrated above, in times of low interest rates, a longer-term GRAT may be more desirable because it allows the senior family member to lock in a low 7520 rate for the duration of the GRAT term. *See* Melcher, *Are Short-Term GRATs Really Better Than Long-Term GRATs?* 22 EST. PL. 23 (2009). In addition, with a longer-term GRAT, the client saves the expenses each time a new GRAT is made for a shorter term, and the client does not have to go through the process of forming and funding a new GRAT.

11. . Insuring the GRAT. As mentioned above, if the senior family member dies during the annuity term, all or a portion of the GRAT assets will be included in his or her gross estate. In that event, the GRAT would be ineffective to pass assets to the senior family member's beneficiaries free from estate or gift tax. In order to "insure" that the GRAT technique works, a life insurance policy can be purchased on the senior family member's life which coincides with the term of the GRAT and the assets contributed to it (e.g., for a 10-year GRAT, the client would buy a 10-year term policy with a face value equal to the projected estate tax that would otherwise be imposed if the GRAT fails). Such a policy would presumably be purchased by an irrevocable life insurance trust ("ILIT") so that the proceeds of the policy would not be subject to estate tax upon the senior family member's death.

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

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

Example: Charlie, 61, sold his business this year for \$10 million. He started the business years ago on a shoestring, so he has a large capital gain. In addition, part of the purchase price was for a "non-compete" agreement, which will be ordinary income to Charlie. He contributes \$1,000,000 to a 20-year CLAT in April, 2014. He structures the CLAT to pay out 5% of the value of the assets initially contributed to the trust, so the CLAT will pay his favorite charity \$50,000 per year for the next 20 years. (Charlie was already contributing this much to charity, so he no longer needs to budget for that from his other funds). In addition to benefiting charity over the long run, Charlie gets a \$802,010 income tax deduction, which goes a long way toward offsetting the income-tax bill he triggered earlier in the year. The remaining value (\$197,990 in this example) will be treated as a gift by Charlie to the remainder beneficiaries of the CLAT (in his case, his children). Charlie will use part of his \$5.34 million lifetime gift tax exemption and not have to pay gift tax on the gift to his kids. If the trust invests its assets at an average return of 8% per year, the trust will have nearly \$2.4 million in it at the end of the 20th year, even after paying \$50,000 per year to Charlie's favorite charity. This property will pass to Charlie's kids at a cost of only \$197,990 of Charlie's gift tax exemption. One caveat that clients have to remember: As with most gifting strategies, once you put money into one of these trusts, you can't get it back. The trust has to be irrevocable to work.

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

Specifics.

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

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

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

4. Income Tax Issues. One of the most important considerations related to the structure of a CLAT is the income tax effects. If the CLAT is structured as a grantor trust for income tax purposes, then the grantor is entitled to receive an up-front income tax charitable deduction equal to the present value, based on IRS tables, of the interest passing to charity. IRC § 170(f)(2)(B). The charitable deduction is typically subject to the 30%-of-AGI deduction limitation, since the gift is treated as a gift for the use of charities. Treas. Reg. § 1.170A-8(a)(2). Beware of other limits on the income tax deduction if property other than cash is contributed to the CLAT. *See* IRC § 170(e). Of course, to get this deduction, the CLAT has to be a grantor trust, which means that the grantor must pay tax on all of the CLAT's income during its term. If a grantor trust structure is chosen, the grantor gets no additional deduction for amounts paid by the trust to the charity during the term of the CLAT. In addition, if the grantor toggles off grantor trust treatment, the consequence is the same as if the grantor died during the term of the CLAT, as described below. If the CLAT is *not* structured as a grantor trust, then the grantor is not entitled to any income tax charitable deduction for amounts paid to charity. Instead, the CLAT is responsible for the payment of the income taxes attributable to any income earned by the CLAT. In that event, the CLAT receives an income tax deduction for the amount paid to charity each year. IRC § 642(c)(1).

5. Death During Term. If the grantor dies during the term of the CLAT, none of the trust assets will be included in the grantor's estate, since the grantor has not retained any interest in the trust. If grantor trust treatment was used to give the grantor an initial income tax deduction, and if the grantor dies (or grantor trust treatment is otherwise terminated) during the trust term, the grantor must recapture income equal to the value of the deduction he previously received less the present value of trust income paid to him, discounted to the date of contribution to the trust. IRC § 170(f)(2)(B).

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

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

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

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

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

Example: Gary and Gwen have four married children and seven grandchildren. In March, 2009, they decide to make gifts to their children, in-laws and grandchildren using their annual gift tax exclusion ($13,000 in 2009). With four children, their four spouses, and seven grandchildren, Gary and Gwen can each make 15 annual exclusion gifts, for a total of $390,000. Gifts to the grandchildren are placed into custodial accounts, with a parent of each grandchild serving as custodian. In this case, each donee used the funds received to buy a Dow Jones index fund when the average stood at about 6,700. With the Dow now trading at over 16,000, the current value of assets transferred out of Gary and Gwen's estate is nearly $940,000.

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

Specifics:

1. What to Give. Despite the basis issues discussed below, estate planners generally recommend making outright gifts when market conditions are depressed–sometimes called "natural discounting" (i.e., making gifts of stock when the stock market takes a significant downturn, or gifts of real estate when the real estate market is depressed). As mentioned above, post-gift appreciation lands in the junior generation's hands with no gift or estate tax. In the first example above, if Gary and Gwen consistently make annual exclusion gifts for 10 years, and if the donees invest the funds only at 5% per annum, Gary and Gwen could move over $5.1 million from their estates with no gift or estate tax. In the second example above, even if no additional gifting were done, if Dave's kids invested the gifted property at 5% per annum for ten years, the property would grow to nearly $14 million. All of this growth would be removed from the senior family member's estate and pass to the junior family members, free of gift and estate tax.

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

$1,371,429, exactly recapturing the benefit that the kids received from the gift.

3. Carry-Over Basis. In making gifts, the issue of basis is always important. While an inherited asset generally gets a new cost basis equal to its value for federal estate tax purposes, property received by gift generally receives a carryover of the donor's basis, increased (but not above fair market value) by the amount of any gift tax paid with respect to the gift. IRC § 1015. In fact, if the beneficiary sells the property for less than the donor's basis, the beneficiary may have his or her basis limited to the fair market value of the property at the date of the gift, if that value is less than the donor's basis. IRC § 1015(a). However, with top capital gains rates at 23.8% and the top estate tax rate at 40%, in most situations, a gift is still more beneficial from an overall tax perspective. This is especially true if the gifted asset is held for a long period of time (thereby deferring the recognition of any income tax payable on the gain), and continues to appreciate in value after the gift is made. One can determine how much an asset must appreciate for any estate tax savings to exceed the income tax costs of a loss of basis step-up by applying an algebraic formula to compute a "tax efficient appreciation factor." The formula of 1 + [Unrealized appreciation x ((Income tax rate/(Estate tax rate-Income tax rate)) / Total gift] provides a growth multiple by which the gifted asset needs to appreciate to create estate tax savings sufficient to offset the income tax liability inherent in the appreciation at the time of the gift. For example, a $5 million gift with $1 million of unrealized appreciation would need to appreciate by a factor of 1.15 (to $5.75 million) for the estate tax savings to offset the income tax cost associated with a loss of step-up in basis: 1 + [$1 million x ((.15/(.35-.15))/$5 million] = 1.15. See Mahon, *The "TEA" Factor*, 150 TR. & EST., Aug, 2011 at p 46.

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

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

F. Self-Cancelling Installment Notes. What if your client may not survive to his or her actuarial life expectancy? People in this unfortunate situation may consider selling assets (especially undervalued assets) to a junior family member. If a simple note is given for the purchase price, the potential to move appreciation is the same as for other transactions discussed above. But where life expectancy is an issue, the payment given in exchange for the asset can take the risk of death into account. The most popular forms of payment in these circumstances are self-cancelling installment notes ("SCINs") and private annuities (discussed below).

The Technique: As its name suggests, a self-cancelling installment note is a promissory note providing that if the seller/lender dies before the note is paid in full, any unpaid amounts are cancelled. The seller's death during the term of the note creates a windfall to the buyer, because he or she won't have to make any further payments on the note, regardless of the amount of the outstanding balance. To compensate the seller for the risk of losing money because of an early death, a SCIN must provide a "kicker," in the form of extra interest, extra principal, or both, that will be received if the seller survives. Since the buyer's obligation to make any future payments on the note is cancelled upon the seller's death, no value is included in the seller's estate for any unpaid amounts. Of course, the amounts received by the seller during his or her lifetime (to the extent not consumed, given away, or otherwise disposed of) will be included in the seller's estate. The IRS publishes life expectancy tables that can be used to value the SCIN premium, so long as the seller isn't "terminally ill." The buyer can be a junior family member or an IDGT. *See* Bisignano, *Estate Planning for the 'Terminally Ill' Client–A Checklist for the Estate Planning Advisor*, 33rd Annual State Bar of Texas Adv. Est. Pl. & Prob. Course (2009).

Example: In January 1995, Scott, then age 70, was not terminally ill but was not expected to live for his actuarial life expectancy. Scott sold FLP units having an undiscounted value of $10,000,000 and a discounted value of $7,000,000 to an IDGT for the benefit of his children and grandchildren in exchange for a 9-year SCIN. Scott died at the beginning of year 8 of the 9-year term, when the FLP assets had appreciated to $20,000,000 (or roughly 10.4% per year, compounded annually). The required interest rate on the SCIN, including the mortality risk premium, was 13.864%, corresponding to an annual interest payment of $970,480. Over the first 7 years of the SCIN, the trust paid Scott a total of $6,793,360 in interest payments. The remaining $13,206,640 of value of the FLP units was retained by the IDGT without any gift or estate tax inclusion in Scott's estate. If, instead, this transaction had occurred in April, 2014, the required interest rate on a SCIN for a 70-year-old, including the mortality risk premium, would have been 5.514%, corresponding to an annual interest payment of only $385,980. Over the first 7 years of the SCIN, the trust would have paid Scott a total of $2,701,860 in interest payments. The remaining $17,298,140 of value of the FLP units (nearly $4.1 million more than that in the prior example) would have been retained by the trust.

Specifics:

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

2. Risk Premiums. Because the buyer's obligation to pay back the note could terminate on the senior family member's death during the note term, a mortality risk premium must be charged. This risk premium can take the form of a higher interest rate, a higher sales price, or both. In any event, the exact amount of the premium is presumably determined by the senior family member's actuarial life expectancy (based on IRS tables). The older the senior family member is, the higher the risk premium must be. If a premium is not paid, the transaction may constitute a bargain sale, resulting in a gift from the senior family member to the buyer. *See, Costanza Est. v. Comm'r*, 320 F.3d 595 (6th Cir. 2003). Note that while most commentators *assume* that the premiums for SCINs should be based upon IRS actuarial tables, there is no express authority for this proposition. The IRS has recently taken the litigation position that those tables may not apply when valuing a SCIN, even if the taxpayer's actual life expectancy is within the safe harbor for use of those tables discussed below. The IRS has argued that (i) the notes may not be valid notes if the buyer may lack the wherewithal to pay the note and a substantial SCIN premium; and (ii) the Section 7520 valuation tables do not by their terms apply to promissory notes, and instead a willing-buyer willing-seller standard must be used to value the notes, based upon the seller's actual medical history on the date of the gift. *See* IRS Chief Counsel Advice CCA 201330033; *Davidson v. Comm'r*, T.C. Docket No. 013748-13.

3. Death Before Maturity. If the senior family member dies prior to the SCIN's maturity date, any unpaid principal or accrued interest is not includible in his or her estate. *Est. of Moss*, 74 TC 1239 (1980), *acq. in result in part* 1981-2 CB 2. On the other hand, if the senior family member lives until the note fully matures, he or she will receive not only the full payment price, but also the interest or purchase price premium. While Section 61(a)(12) generally treats debt forgiveness as income to the borrower, forgiveness of indebtedness that takes the form of an inheritance is an example of the "detached and disinterested generosity . . . affection, respect, admiration, charity or like impulses" that characterize a gift excludable from the recipient's income. *See*, *Comm'r v. Duberstein*, 363 U.S. 278, 285 (1960). It is well settled that cancellation of a debt can be the means of effecting a gift. *See*, *e.g.*, *Helvering v. American Dental*, 318 U.S. 322 (1943). A testamentary cancellation of a debt owing to the decedent can similarly be the means of effecting a gift in the form of a bequest. TAM 9240003.

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

IRS has recently taken the litigation position that those tables do not apply to value a SCIN, even if the taxpayer's actual life expectancy is within the safe harbor described above. *See* IRS Chief Counsel Advice CCA 201330033; *Davidson v. Comm'r*, T.C. Docket No. 013748-13.

5. Impact of Interest Rates. As the foregoing example illustrates, like traditional intra-family loans, SCINs work best when interest rates are low. In a low interest rate environment, the interest rate on a SCIN, including the mortality risk premium, can be significantly lower than even a traditional note in a high interest rate environment. Likewise, a SCIN's benefits can be amplified when used in conjunction with a sale of discounted or appreciating assets, such as limited partnership units in an FLP, membership units in an LLC or (non-voting) shares in a private corporation, to an intentionally defective grantor trust.

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

The Technique: A private annuity is similar to a self-cancelling installment note arrangement. Instead of giving a note, the buyer promises to make a fixed annual payment to the seller for life, no matter how long the seller lives. Since the annuity payment obligation terminates at death, no value is included in the seller's estate for any unpaid amounts. Of course, the amounts received by the seller during his or her lifetime (to the extent not consumed, given away, or otherwise disposed of) will be included in the seller's estate. The IRS publishes life expectancy tables that can be used to value the private annuity, so long as the seller isn't "terminally ill." As is the case with the SCIN, the buyer can be a junior family member, or an IDGT. Because of a recent IRS ruling regarding the income tax issues associated with private annuities, an IDGT is the preferred choice as an issuer of private annuities. *See,* Bisignano, *Estate Planning for the 'Terminally Ill' Client–A Checklist for the Estate Planning Advisor*, 33rd Annual State Bar of Texas Adv. Est. Pl. & Prob. Course (2009).

Example: In January 1995, Patrick, then age 70, sells FLP units having an undiscounted value of \$10,000,000 and a discounted value of \$7,000,000 to an intentionally defective grantor trust for the benefit of his descendants in exchange for a lifetime private annuity. Patrick dies 9 years later, when the assets held by the FLP have appreciated to \$18.7 million (roughly 7.2% per year, compounded annually). In 1995, the applicable interest rate would have been 9.6%, requiring the trust to pay Patrick \$1,067,399 annually. Over the 9-year term of the annuity, Patrick would have received a total of \$9,606,591 in annuity payments. The remaining \$9.1 million of value would have been retained by the trust If, instead, the sale had taken place in April, 2014, the applicable interest rate would have been 2.2%, requiring the trust to pay Patrick only \$600,045 per year. Over the 9-year term of the annuity, Patrick would have received only \$5,400,401 in annuity payments, leaving nearly \$13.3 million in value in the trust (about \$4.2 million more than in the prior example).

Specifics:

1. Private Annuities. A private annuity works much like a SCIN. The senior family member transfers assets to a junior family member in exchange for junior's promise to make fixed payments to senior for the remainder of senior's life. Because the annuity terminates upon the senior family member's death, it is not includible in his or her estate. For gift tax purposes, the value of the annuity payments is based on the Section 7520 rate and the senior family member's life expectancy. If the fair market value of the assets transferred from senior to junior equals the value of the annuity, there is no gift tax due. As with a SCIN, the senior family member may use the standard mortality tables of Section 7520 of the Code, provided that he or she is not "terminally ill." Treas. Reg. § 25.7520-3(b)(3). As explained above, the Treasury Regulations provide that an individual is terminally ill if he or she has at least a 50% chance of dying within one year, but there is a rebuttable presumption that the individual is not terminally ill if he or she lives at least 18 months after the transfer. *Id.*

2. Income Taxation of Annuity Payments. Until fairly recently, the IRS treated a private annuity much like a SCIN for income tax purposes, with the senior family member reporting any gain ratably over the annuity term. *See* IRC § 72; *see also* Rev. Rul. 69-74, 1969-1 CB 43. However, under proposed regulations, the ratable recognition approach is not available in the context of a sale for a private annuity.

Instead, for annuity contracts received after October 18, 2006, the senior family member is required to recognize gain at the time the assets are transferred in exchange for the annuity. Prop. Treas. Reg. § 1.1001-1(j), Treas. Reg. § 1.451-1(a). Note, however, that these regulations are merely proposed, and are not binding on taxpayers until they become final. Note also that if the assets are sold to a grantor trust, no gain is recognized on the sale. *See* Rev. Rul. 85-13, 1985-1 CB 184.

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

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

5. Outliving the Tables. Unlike a SCIN, the payments under a private annuity need not end at a fixed maturity date (so long as the exhaustion test is met), but may be extended for the client's lifetime. This continuation of payments may be a comfort to clients who are concerned about giving away "too much," and not retaining enough to support themselves for the rest of their lives. But like a SCIN, a private annuity poses an estate tax risk that the payments made will actually add value to the senior family member's estate if he or she lives to maturity. In fact, if the private annuity is structured to require payments for the lifetime of the transferor, and if the senior family member lives well beyond his or her life expectancy, these additional payments can add substantial value (and taxable income) to the recipient's estate.

6. Best Time for Private Annuities. Like SCINs, private annuities can be used in conjunction with a sale of appreciating assets, such as limited partnership units in an FLP, membership units in an LLC or (non-voting) shares in a private corporation, to an intentionally defective grantor trust. They work best when interest rates are low because the annuity payments required to be made by the buyer to the senior family member will be lower, thereby allowing the trust to retain more of the transferred assets at no transfer tax cost to the senior family member. *See* Streng & Davis, RETIREMENT PLANNING: TAX AND FINANCIAL STRATEGIES ¶16.03 (Warren Gorham &Lamont 2011).

H. Sale 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. Unlike the tools discussed above, 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 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 would be set up for the benefit of the senior generation, 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: 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 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 trust assets, when added to Mary's other assets, are well below the estate tax exemption of $5 million. Mary's executor uses some of Mary's $5 million GST 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. The amount of the APGT's property subject to the general power could be limited by a formula to ensure that the trust doesn't cause estate tax to be payable when the senior family member 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.

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 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 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 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 IDGTs, rapidly appreciating or leveraged assets are ideal candidates for sale. The use of lack-of-marketability and minority interest discounts can increase the benefits of the technique.

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

The Technique: Unlike a conventional family limited partnership with a single class of limited partners, a preferred partnership is typically recreated by the senior family member contributing assets to a partnership that has at least two classes of limited partnership interests. One class provides the holder with a preferred right to receive distributions of income and liquidation proceeds, much like traditional preferred stock. The other class (the common interest) gets any return above the preferred return, and receives liquidation proceeds only after creditors and the preferred holders are paid in full. The economic consequence of this structure is that the holder of the preferred partnership interest can never receive more than the annual preferred payments of income, and its liquidation preference. Any other income, cash-flow, liquidation proceeds or other return belongs to the holders of the common partnership interests. The senior family member might then (i) give the preferred interest to a GRAT or CLAT; and/or (ii) give all or a portion of the common interest to junior family members (or to a trust or IDGT for their benefit). If the junior family members (or trust) have assets of their own, they might contribute those assets directly to the partnership in exchange for common partnership interests. If properly structured, the common limited partnership interests will be valued based not only upon discounts for lack of control and lack of marketability, but will also have their value reduced by the value of the preferred partnership interest.

Example: Fred places $10,000,000 worth of stocks, bonds, real estate, and other holdings into a limited partnership which (in addition to a 1% general partnership interest retained by Fred), provides for two classes of limited partnership interests. The preferred interest is entitled to receive the first $350,000 of partnership distributions made in any year. Any partnership distributions in excess of $350,000 per year are paid to the common partnership interest owners. If partnership distributions are less than $350,000 in any year, the unpaid amount is carried forward as a preference owed to the holders of the preferred interest in future years. In addition, when the partnership liquidates, the preferred owners are entitled to receive the first $5,000,000 worth of liquidation proceeds, with any excess passing to the holders of the common interests. If the assets in the partnership grow at 10% per year for fifteen years, the holders of the preferred interest would receive $350,000 per year, plus $5,000,000 upon the liquidation of the partnership, while the holders of the common interest would be entitled to receive the balance of the partnership assets, over $25,652,000. The preferred interests are effectively "frozen" in value at $5,000,000 while the common interests enjoy the balance of the growth.

Specifics:

1. Structure of the Preferred Partnership. Section 2701 of the Code provides that when a person transfers an interest in a corporation or limited partnership to a "member of the transferor's family" (generally, the transferor's spouse, descendants of the transferor or transferor's spouse, or the spouses of those descendants), certain rights retained by the transferor must be valued at zero. These "applicable retained interests" include (i) any distribution right if, immediately before the transfer, the transferor and "applicable family members" have control of the entity; and (ii) a liquidation, put, call or conversion right. For purposes of the control test, "applicable family members" mean the transferor's spouse, ancestors of the transferor or spouse, a spouse of those ancestors, or any descendants of a parent of the transferor or transferor's spouse. Valuation of the retained payment rights at zero is problematic, because the regulations generally require any gift of an interest in the corporation or partnership to be valued at the value of all interests held before the gift, less the value of the interests retained by the transferor. Fortunately, there are several exceptions to the rules requiring a zero valuation, and the preferred partnership takes advantage of these exceptions. Two notable exceptions are available to estate planners. First, the valuation rules of Section 2701 generally do not apply if the transferor gives away the preferred interest and retains the common interest. IRC §2701(c)(1)(B)(i); Treas. Reg. §25.2701-2(b)(3)(i). Second, a preferred interest will not be valued at zero so long as the preferred rights retained by the transferor are rights to a "qualified payment." A "qualified payment" means a dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under a partnership agreement) to the extent that the dividend is payable at a fixed rate. A cumulative distribution payable at least annually at a fixed rate or amount is a qualified payment. Treas. Reg. §25.2701-2(b)(6). If the distribution is made up to four years following its due date, it is treated as having been made on time. *Id*. If the payment is made after the four year grace period, it must essentially accrue interest at the discount rate in effect at the time the transfer was made. Treas. Reg. §25.2701-4(c)(3). The senior family member should avoid retaining any "extraordinary payment rights," such as puts, calls, conversion rights, or the right to compel liquidation, the exercise or nonexercise of which affects the value of the transferred interest. Treas. Reg. §25.2701-1(a)(2)(i). *See*, Angkatavanich and Varger, *Preferred Partnership Freezes*, 150 TR. & EST., May 2011 at 20.

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

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

4. Giving Away the Preferred Partnership Interest. Remember that the special valuation rules do not apply if the transferor gives away the preferred partnership interest and keeps the common interest. A preferred payment right with, for example, a 7% guaranteed return, could presumably be given to a GRAT or a CLAT when the Section 7520 rate is significantly lower than the preferred payment rate (the Section 7520 rate was 2.2% in April, 2014). So long as the partnership is able to make its payments at the stated rate, when the trust terminates, the remainder beneficiaries are certain to receive the arbitrage between the guaranteed rate and the Section 7520 rate in effect when the trust was formed. For example, under current interest rates, a gift of a 7% guaranteed payment partnership interest would ensure a wealth transfer of 4.8% annually (the 7% payment rate less the 2.2% Section 7520 rate).

5. Giving Away the Common Partnership Interest. If the preferred partnership interest is structured with a "qualified payment," then the interest will not be valued at zero for purposes of Section 2701.

As a result, if the transferor retains that interest while giving away the common partnership interest, the common interest can be valued by subtracting the value of the preferred interest from the value of all of the interests held by the transferor prior to the transfer. In other words, in addition to the usual discounts for lack of control and lack of marketability, an additional discount may be taken for the value of the preferred interest retained by the transferor.

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

V. A NEW ESTATE PLANNING PARADIGM.

A. New Prominence for QTIP Trusts? Some estate planners have suggested a new paradigm for estate planners to consider. They argue that the "default" approach for high-net-worth clients who are likely to have little estate tax exposure (e.g., married clients with net worth in the $2 to $8 million range) should no longer be "marital-lead-residuary-bypass-trust," or "all-to-spouse with disclaimer to bypass trust." They suggest instead that the starting point for estate planning should be all to a QTIPable trust for spouse. The thought process is as follows:

1. Bypass Trust Benefits. In a world with lower estate tax exemptions and no portability, bypass trusts were the tool of choice. They offer a number of tax and non-tax benefits, similar to dynasty trusts. The non-tax benefits include creditor and divorce protection for the surviving spouse, management assistance through the use of a trustee or co-trustee, control over the ultimate disposition of assets for the transferor, and other advantages. The primary tax benefit, of course, is that the assets in the bypass trust avoid estate taxation at the time of the surviving spouse's death, and preserve the GST exemption of the first deceased spouse. Higher estate tax exemptions and the advent of portability, however, have reduced or eliminated the need for bypass trusts to ensure estate tax savings for many clients. A traditional formula bequest that places the tax-exempt amount into the bypass trust may, in many cases, cause the entire estate of the first spouse to die to pass into the bypass trust.

2. Bypass Trust Costs. Bypass trusts have always suffered from some tax and non-tax detriments. From an income tax standpoint, bypass trusts suffer the disadvantages of compressed income tax brackets and a loss of step-up in basis at the death of the surviving spouse. Non-tax detriments include increased costs of estate administration and funding, and ongoing costs and inconvenience associated with administering the trust. Increases in income tax rates, both for ordinary income and capital gains, compounded by the 3.8 percent tax on undistributed net investment income, have exacerbated the income tax costs of bypass trusts. At the same time, offsetting estate tax savings have been reduced or eliminated. Therefore, for many clients, the "cost" of using bypass trusts may be seen to outweigh the benefits.

3. Contrast the QTIPable Trust. Placing property into a trust eligible for the estate tax marital deduction offers many of the same non-tax benefits as bypass trusts. 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, and control over the ultimate disposition of assets for the transferor. Of course, to be eligible for QTIP treatment, these trusts must distribute all income at least annually to the surviving spouse. IRC § 2056(b)(7)(B). While they are subject to the same compressed income tax brackets as are bypass trusts, less income may be accumulated in QTIP trusts at those rates. In addition, 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. If no QTIP election is made, the first spouse to die is treated as the transferor for GST tax purposes, so GST exemption may be allocated (or may be deemed allocated), thereby preserving the GST 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 purposes, again utilizing the decedent's GST exemption to shelter the QTIP assets from tax in succeeding generations. *See* IRC § 2652(a)(3). From an estate tax standpoint, making the QTIP election means that the assets in the QTIP trust will be taxed at the surviving spouse's death as though they were part of his or her 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 that amount plus the deceased spouse's DSUE amount) then no estate tax will be due. In short, QTIP trusts may offer many of the benefits of bypass trusts, without many of the tax detriments.

B. QTIP Trust Disadvantages. Even in the current tax regime, however, QTIP trusts pose some disadvantages over 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, a QTIP trust trustee cannot "sprinkle" trust income and principal among younger-generation family members. But 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 large taxable gifts without paying any tax by using the 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 estate tax exemption (including the DSUE amount, if 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, then with hindsight, one could argue that using a bypass trust instead would have been more beneficial to the family.

3. Income Tax Exposure. A QTIP trust is a "simple" trust for federal income tax purposes, in that it must distribute all of its income at least annually. Remember, however, that simple trusts may nevertheless pay income taxes. 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. 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.

C. Building in Flexibility. So is a QTIP trust the best solution? It may be difficult to tell which estate planning situation is best while both spouses are alive. In those circumstances, estate planners may be well advised to build as much flexibility into the estate plan as possible.

1. Disclaimer Bypass Trusts. With proper planning, when the first spouse passes away, the surviving spouse can take a "second look" at their financial and tax picture. If the total combined estates will be less than the applicable exclusion amount (including any DSUE amount) then in effect, the survivor can allow the assets to pass to the QTIP trust, and the executor can file an estate tax return making the QTIP and DSUE elections. 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 could provide that the disclaimed amount passes into the bypass trust. Of course, with the continued uncertainty of the tax laws, anticipating future estate tax exposure can be tricky, even in a world of so-called "permanent" estate and gift tax laws. In order for the disclaimer to be effective, it must comply with the technical requirements of the Texas Probate Code and Internal Revenue Code. *See* Tex. Prob. Code[12] § 37A; IRC § 2518. The disclaimer must be filed within nine months of the date of death *and* before any benefits of the disclaimed property are accepted. 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

[12] Don't forget that as of January 1, 2014, the Texas Probate Code no longer exists, and we now have the Texas Estates Code.

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 prevents 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) Examples (4)-(5).

2. 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.

For portability, an executor must file an estate tax return to elect portability even though the return is not required to be filed for estate tax purposes because the value of the estate is below the filing requirement. 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. But, 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 a QTIP election made on a portability return might be treated as an election that "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. But the Revenue Procedure itself 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 themselves make explicit reference to QTIP elections in returns filed to elect portability but not otherwise required for estate tax purposes. *See* Treas. Reg. §20.2010-2T(a)(7)(ii)(A)(4). Moreover, 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 very likely that this guidance will authorize QTIP elections even for estates where no estate tax is otherwise due.

3. *Clayton* QTIP Trusts. When QTIP trusts were first enacted, the IRS strictly construed language in Section 2056(b)(7) requiring the property in question to have passed 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. Its regulations also adopted this position. After the Tax Court found in favor of this position, the Fifth Circuit reversed and remanded, holding that language in a Will which 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 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 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 spouse to die (often, the surviving spouse) time to evaluate whether a QTIP or bypass trust is best. Because the QTIP election would need to be made on an 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.

4. The Three-Choice Option. Can a couple who is unsure that any trust is needed maintain the flexibility to opt out of trust planning at the death of the first spouse? Many clients may prefer not to do so, since it would allow the surviving spouse to opt out of creditor protection, and alter a dispositive plan that controls the ultimate disposition of the property. But for those clients who want the option to "keep it simple," there might be a way to do so. It seems clear that a bequest could be made to the surviving spouse which, upon disclaimer, would pass to a *Clayton* QTIP trust. The *Clayton* election would then leave assets in the QTIP trust or direct them to a bypass trust. As discussed above, the resulting trusts could not offer the spouse a power of appointment without running afoul of the disclaimer rules. A more aggressive approach might involve a bequest to a *Clayton* QTIP trust, with property passing to a bypass trust to the extent no QTIP election is made. A possible twist would be that the Will would include language which provides that if the *Clayton* election is made so that property will pass to a QTIP trust, if the surviving spouse disclaims the bequest to the QTIP trust, and if one or more of the remainder beneficiaries of the QTIP trust consent, the disclaimed property would pass outright to the surviving spouse. Can a spouse, by disclaimer of his or her interest in a trust, effectively cut off the interest of the trust's remainder beneficiaries? Section 37A of the Texas Probate Code provides that upon the disclaimer of an interest in property, "*[u]nless the decedent's will provides otherwise*, the *property* subject to the disclaimer shall pass as if the person disclaiming or on whose behalf a disclaimer is made had predeceased the decedent and a future interest that would otherwise take effect in possession or enjoyment after the termination of the estate or interest that is disclaimed takes effect as if the disclaiming beneficiary had predeceased the decedent." (emphasis added). A plain reading of the statutory language suggests that the decedent's Will can provide where the disclaimed property (including a future interest that would otherwise take effect) will pass in the event of a disclaimer. Moreover, Section 2518(b)(4) of the Internal Revenue Code provides that to be a valid disclaimer, the disclaimed interest must pass without any direction on the part of the person making the disclaimer and pass either to a person other than the person making the disclaimer *or* to the spouse of the decedent. Therefore, both state law and the Internal Revenue Code indicate that so long as the Will directs the disclaimed property to the surviving spouse, there is no impediment to achieving this result. Query whether the spouse's retained right to direct property to herself by means of a disclaimer might be considered a general power of appointment under Code Section 2041(a)(2), the lapse of which might be treated as a gift by the spouse under Code Section 2041(b)(2). So long as the executor making the QTIP election is not the surviving spouse, and so long as the right to disclaim does not arise unless the QTIP election is made, Section 2041 should not apply unless the QTIP election is in fact made. Treas. Reg. § 20.2041-3(b). If the QTIP election is made by the executor, because the Will provides that a remaiderman must consent in order for the disclaimer to be effective, the disclaimer should not be treated as a general power of appointment since it requires the consent of an adverse party. *See* Treas. Reg. § 20.2041-3(c)(2).

D. 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). The Texas Probate Code essentially incorporates this rule by reference. *See* Tex. Prob. Code § 322A(*l*). 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." Consider the following example:

Example: H & W each have a $10 million estate. H dies with a Will leaving all to a QTIP trust for W, with the remainder passing to his children from a prior marriage. H's executor files an estate tax return making both the QTIP and the portability election. 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 basic exclusion amount and H's DSUE amount to eliminate the tax. Upon W's later death, the QTIP is subject to estate tax under Section 2044 of the Code. Since W used all of her applicable exclusion amount for sheltering 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, resulting in an estate tax liability to H's children of $4 million. 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. What to Do with Old Bypass Trusts. If your client passes away with an estate plan that is, in effect, all to a bypass trust, even though no estate tax is likely to be achieved, is there any way to minimize the associated tax costs?

1. Strategies for Income Tax Rates. As noted in Section J above, income (including net investment income) tax costs can be managed to some extent by (i) adopting a tax-efficient investment strategy; and (ii) managing distributions (including, if the trust permits, distributions to children or other younger-generation beneficiaries) to pass income out to persons who occupy lower tax brackets than the trust. Naturally, investment policies and distribution practices are subject to overarching fiduciary duties—tax efficient strategies are not the only determining factor. Nevertheless, suitable investments in tax-advantaged accounts, buy-and-hold investments, and timely distributions to lower-tax-bracket beneficiaries can minimize the income tax impact of having assets held in a bypass trust.

2. Strategies for Basis Adjustment. Achieving a basis adjustment (hopefully, a step-up in basis) upon the death of the second spouse is more problematic, but not impossible.

a) Grant of General Power By Third Party. Some estate planners have recommended that when drafting the Will, a provision be included which appoints a "trust protector" or other party who is given the authority to grant the surviving spouse 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 and thereby achieve a step-up. This approach has a number of shortcomings, not the least of which are (i) it must have been included in the governing instrument; (ii) a person (or persons) willing to hold this power must be identified; and (iii) the person must be willing to exercise the authority at the right time (What if the surviving spouse exercises the power and diverts the assets to a caregiver? Is the trust protector liable to the remaindermen?).

b) Formula General Power of Appointment. Perhaps instead the Will could be drafted to grant a formula general power to the surviving spouse. This formula might permit the spouse to appoint the lowest-basis assets of the bypass trust having a fair market value which, when added to the spouse's other assets, does not cause estate tax. Thus, the trust might provide that the power applies to the most appreciated asset first, cascading to each next individual asset until the unused exemption amount is reached. The power may limit the scope of eligible beneficiaries so long as creditors of the power holder are included. For example: "I grant my spouse the testamentary power to appoint to any of my descendants or to any trust primarily therefore. My spouse also may appoint to creditors of his or her estate." IRC §2041(b)(1). *See also*, *Estate of Edelman v. Comm'r*, 38 T.C. 972 (1962), *Jenkins v. U.S.*, 428 F.2d 538, 544 (5th Cir. 1970). If the power is to be further limited, its exercise could require the consent of an independent third party. A power is still a general power if it may only be exercised with the consent of a non-adverse party. IRC § 2041(b)(1)(C)(ii), Treas. Reg. § 20.2041-3(c)(2). For more on this technique, see Morrow, *Increase Tax Efficiency with the Optimal Basis Increase Trust*, J. OF FIN. PL. (Oct 2013).

c) Distribution of Low-Basis Assets. Another approach involves having the trustee 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 her estate to be less than her available applicable exemption. Arguably, this distribution could be undertaken with no special language in the governing instrument beyond the authority to distribute assets to the spouse for health, support, maintenance and education. So long as the spouse passes these assets at death to the same person(s) who would have received them from the bypass trust, there is presumably no one to complain. The remaindermen receive the assets with a higher cost basis, so are actually better off than if the distribution had never been made. This solution, too, 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); 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 was thereby imposed for the remainder beneficiaries, effectively excluding the assets from the spouse's estate (and precluding a step-up in basis). *See Stansbury v. U.S.*, 543 F. Supp. 154, 50 AFTR 2d 82-6134 (N.D. Ill. 1982), aff'd 735 F.2d 1367 (7th Cir. 1984) (assets subject to constructive trust excluded from estate of nominal owner for estate tax purposes).

d) Springing the Delaware Tax Trap. What if the bypass trust in question wasn't drafted with any form of express general power of appointment, whether to be granted by a third party or by formula? If no such authority has been granted, but the bypass trust grants the spouse a special testamentary power of appointment, there is another option. Remember that normally, holding or exercising a special 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). This sort of exercise gives rise to the so-called "Delaware Tax Trap." 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). Springing the Delaware Tax Trap could be the subject of a seminar in itself, but suffice it to say that under the 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 the recipient of the property a presently exercisable general power of appointment. *See* REST. TRUSTS 3d § 56 cmt. b. Thus, for example, the surviving spouse could appoint low-basis bypass trust property into trusts for the children which then grant the children inter vivos general powers of appointment. The exercise of a limited power of appointment in this manner would permit the children to appoint the property in further trust, restarting the applicable rule against perpetuities. As a result, the exercise of the limited power of appointment would generate a step-up in basis at the surviving spouse's death under Section 1014(b)(9) of the Code (albeit presumably at the cost of a loss of creditor protection and generation-skipping transfer tax exemption for the children). If the spouse wished 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 presently exercisable general power of appointment. Note, though, that whomever held 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 presumably be subject to the claims of that person's creditors.

VI. 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. As always, even with permanence, we live in an ever changing but never boring world of estate planning.

Exhibit A

Sample Letter Regarding Portability

____
____
____

Re: Estate of ________________, Deceased

Dear _________________:

As we have discussed, it does not appear that the preparation of a Federal Estate Tax Return (Form 706) will be required since [your spouse]'s estate did not exceed [$5,340,000] for the year [2014]. However, you may elect to have a Form 706 prepared and filed to be eligible to benefit from a new law effective January 1, 2011, which provides for "portability" of [your spouse]'s federal estate tax exemption to you. The Form 706 must be filed within nine (9) months after [your spouse]'s death (or within fifteen (15) months with a timely filed extension). The cost of preparing a Form 706 is typically between [$_______ and $_______], but may be more or less, depending upon the nature of the estate's assets and resulting complexity of the return.

In effect, portability adds [your spouse]'s unused federal estate tax exemption ("exemption") to the federal exemption available to you, both for federal gift and estate tax purposes. For example, if your [spouse] left everything outright to you, none of [his/her] exemption was used since everything going to you qualified for the unlimited marital deduction. In this example, your [spouse]'s entire [$5,340,000] exemption would be unused. If you file the Form 706 in a timely manner, you and your estate would have the right to apply [his/her] [$5,340,000] of exemption, plus the amount of your own exemption, for gift and estate tax purposes. This would substantially increase the gift tax exemption available to you during your lifetime and estate tax exemption available to you at your death. Continuing the example above, if the exemption is $5,340,000 upon your death, your estate would have [$10,680,000] of available exemption ([$5,340,000] of your [spouse]'s unused exemption plus your $5,340,000 exemption).

One idiosyncrasy of portability is that you are only allowed to use the exemption of your "last deceased spouse." As the statute is written, if you were to remarry, and if your new spouse were to predeceases you, you would not be able to use the excess exemption of your prior spouse, even if you filed the Form 706 for [his/her] estate.

As a result of current law, it is prudent to plan with the assumption that if the value of your estate, including life insurance death benefits exceeds [$5,340,000] (adjusted for inflation each year), there may be estate taxes payable at the time of your death. Filing a Form 706 for [your spouse]'s estate might reduce or eliminate those taxes. The deadline for filing this Form is _______________. If you want to consider filing the Form 706, please contact me as soon as possible.

EXHIBIT B

IRC 1411 Net Investment Income (Preliminary)