EVALUATING PORTABILITY, POTENTIAL PROBLEMS AND THE POST-ATRA PLANNING PARADIGM

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- 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

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EVALUATING PORTABILITY, POTENTIAL PROBLEMS AND THE POST-ATRA PLANNING PARADIGM

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. A key feature of the new estate tax regime is the "portability" of any unused estate tax exemption upon the death of one spouse to a surviving spouse. Introduced in 2010, portability, like the rest of the current estate tax rules, became permanent as a result of ATRA 2012. So, what are the rules? What does all of this mean for clients? What does it mean for estate planners? 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.[1]

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 in 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%. For 2014, after applying the inflation adjustment, the exemption is $5,340,000. For reference, a chart outlining the estate, gift and GST tax exemptions since 1942 is attached as Exhibit A.

2. American Taxpayer Relief Act of 2012, P.L. 112-240. ATRA 2012 really added only three main items of substance to the transfer tax system. First, the highest bracket is 40%. Second, a technical correction addressed a problem known as "clawback" in the case of portability. Third, the law is permanent. The result is that we have permanent, unified estate, gift and GST tax laws with an exemption of $5,000,000, adjusted annually beginning in 2012 for inflation after 2010, and a top tax bracket of 40%. For clients, the high permanent exemption amount combined with continued annual inflation adjustments is a 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, gift and GST tax laws. Prior to 2013, there was continued uncertainty about "will they or won't they," while now, it literally takes an act of Congress to make a change. Now that we do have permanent 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. Some confusing language in TRA 2010 caused estate planners and their clients to be concerned about the possibility of "clawback." Actually, the concerns regarding clawback arose in two areas–traditional transfer taxes and portability. 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 as a result of the inflation adjustment, 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.

[1] Of course, a client may make lifetime use of his or her GST tax exemption without making a corresponding taxable gift, or may make a taxable gift without allocating GST tax exemption. As a result, at death, the remaining amount of these exemptions may be unequal or out of sync.

For portability, the concern centered around the use of the term "basic exclusion amount" as used in two places in the statute and potential limits on the use by a surviving spouse of any unused estate tax exemption received by the spouse as a result of portability. IRC § 2010(c)(4). ATRA 2012 revised the statute so that the term used in Section 2010(c)(4)(B)(i) of the Internal Revenue Code (the "Code") is now the "applicable exclusion amount." By Treasury regulation, the term "basic exclusion amount" as used in Code Section 2010(c)(4)(A) is to be 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). As explained in more detail below, with these two "corrections," the concern regarding clawback in relation to portability is eliminated.

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,[2] the surviving spouse may "inherit" 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 exemption amount is referred to in the statute as the "deceased spousal unused exclusion amount," otherwise known as the "DSUE amount." Once a surviving spouse "inherits" the 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 use only the DSUE amount from his or her "last deceased spouse." A simple example illustrates this concept.

Example 1: H dies in 2011 with an estate of $3 million. He leaves $2 million outright to his wife W, and the balance to his children. As a result, his taxable estate is $1 million ($3 million, less a $2 million marital deduction). The executor of H's estate elects to file an estate tax return using $1 million of H's $5 million estate tax exemption[3] to shelter the gift to the children, and pass (or "port") the other $4 million of H's estate tax exemption to W. W would then have an estate and gift tax exemption of $9 million (her own $5 million exemption plus H's unused $4 million exemption).

1. Portability Vocabulary. To understand portability, it is helpful to have a good grasp of the terms used in the statute and regulations. Most of these terms are discussed in more detail below, but an overview of the vocabulary of portability is a helpful predicate to the discussion that follows.

a) Basic Exclusion Amount. Every individual has a basic exclusion amount equal to the federal gift or estate tax exemption in the year of the transfer. In 2011, this amount was $5 million. In 2014, the basic exclusion amount is $5.34 million. IRC § 2010(c)(3).

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

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

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

e) Last Deceased Spouse. A surviving spouse may only use the exemption of the spouse's "last deceased spouse." IRC § 2010(c)(4)(B)(i). Under the temporary regulations discussed below, "last deceased spouse" means "the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse." But as noted below, at various times based on the timing of transfers made by a surviving spouse, a person may have more than one "last deceased spouse." Temp. Reg. § 20.2010-1T(d)(5). As a result, under some circumstances, a surviving spouse may use the DSUE amount of multiple last deceased spouses.

2. Temporary and Proposed Regulations.[4] Temporary and proposed regulations regarding

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[2] For purposes of portability, as with other federal tax rules, spouses include same-sex couples validly married in the place of celebration. *See U.S. v. Windsor*, 570 US 12 (2013); Rev. Rul. 2013-17, 2013-38 IRB 201. A discussion of this issue is beyond the scope of this outline. For convenience, the examples in this outline denominate spouses as H and W.

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

[4] The authors acknowledge the assistance of Steve Akers, whose pre-ATRA 2012 outline entitled *Portability*

portability were issued on June 15, 2012. In addition, a few general regulations for Sections 2010 and 2505 of Code were also issued. (Interestingly, regulations were never previously issued for those statutes.) The newly issued regulations primarily provide guidance regarding portability. The guidance covers a variety of issues including election requirements, details regarding computing the DSUE amount, and the surviving spouse's use of the unused exclusion amount (either by gifts or for estate tax purposes following the surviving spouse's death).

The regulations generally provide very taxpayer-friendly positions regarding several issues (surprisingly friendly in some cases). 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. 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 and revocable trusts do not contemplate the possibility of preparing an estate tax return if the decedent's estate is not taxable. In most of these existing testamentary documents, no provision permits the executor to prepare the return and no provision directs whether the estate may or may not pay for the preparation of the return. It is easy to imagine situations where a conflict exists as to whether the return should be prepared, such as multiple beneficiaries of the decedent's estate or where the surviving spouse is not a beneficiary of the decedent's estate and the estate passes to the decedent's children (think blended families). After all, portability has the potential to benefit the beneficiaries of the surviving spouse's estate, who may not be the same as the beneficiaries of the decedent's estate. In certain circumstances, making the portability election may actually expose the beneficiaries of the first decedent's estate to unnecessary estate taxes (see the discussion of "The QTIP Tax Apportionment Trap" at page 18 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 compute my unused exclusion amount and thereby permit my spouse to take that amount into account. My Executor may incur and pay reasonable expenses to prepare and file any estate tax return or other documentation necessary to make such election, and to defend against any audit thereof.
>
> -or-
>
> If my surviving spouse so elects, and agrees to pay to or reimburse my estate the reasonable costs incurred by my Executor in preparing and of filing an estate tax return required only to make the required election, my Executor shall make the election described in Section 2010(c)(5) of the Code to compute my unused exclusion amount and thereby permit my spouse to take that amount into account. My spouse shall advance or reimburse to my Executor all reasonable expenses necessary to 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. Generally, a portability election must be made on a timely filed estate tax return (including extensions). IRC § 2010(c)(5)(a). The regulations make it clear that the last return filed by the due date (including extensions) controls. Subject to restrictions when more than one person may make the election (discussed below), before the due date, the executor can supersede the election made on a prior return. After the due date, the portability election (or non-election) is irrevocable. Temp. Reg. § 20.2010-2T(a)(4).

Temporary and Proposed Regulations (Issued June 15, 2012), Copyright © 2012 Bessemer Trust Company, N.A., formed the basis of some of the following discussion.

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 under these circumstances, 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) were permitted to rely on the Revenue Procedure, withdraw their ruling requests, and receive a refund of their user fees, so long as the request was withdrawn before the earlier of IRS action on the request or March 10, 2014. *Id.*

(4) Election on Return. The election is made by filing a "complete and properly-prepared" estate tax return. Treas. Reg. § 20.2010-2T(a)(2). 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" Must Make Election. If there is a court-appointed executor, that person must make the election. The election may not be made by the surviving spouse if someone else is appointed as the executor. (The regulations do not address the situation of having multiple appointed co-executors. 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. *See* Treas. Reg. § 20.6018-2.) If there is no appointed executor (and only if there is no appointed executor), any person in actual or constructive possession of property may file the estate tax return on behalf of the decedent and elect portability (or elect not to have portability apply). *See* IRC § 2203. If a non-appointed executor makes the election, another non-appointed executor (other than a successor to that non-appointed executor) cannot make a contrary election. Temp. Reg. § 20.2010-2T(a)(6)(ii). If there is no appointed executor and if the spouse is in actual or constructive possession of property of the decedent, the spouse could file a return first making the portability election, and no other individual would be able to supersede that election with a subsequent return opting out of the election. However, an appointed executor can supersede an election made by a non-appointed executor so long as the appointed executor does so on a timely filed return. Temp. Reg. § 20.2010-2T(a)(6). If the appointed executor knows that a return has been filed by a non-appointed executor, a statement to that effect should be attached to the new return which includes a description of the executor's authority to supersede any prior election. Even in an estate that might not otherwise require an appointed executor, one should consider having an executor appointed by a court in order to fix in that person the ability to and responsibility for making (or not making) the election.

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

portability, confirming or superseding the return filed by W.

(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 now file a supplemental estate tax return using the revised form to include the computation. 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, special use valuation, or Section 6166 estate tax deferral). Temp. Reg. § 20.2010-2T(a)(7)(ii)(A). Therefore, assets passing to a bypass trust are not eligible for the relaxed valuation rules.

In any event, the executor must exercise "due diligence to estimate the fair market value of the gross estate" including property passing to a spouse or charity. The executor must identify the range of values within which the "executor's best estimate" of the gross estate falls. (The temporary regulations advised that until the instructions for the estate tax return were finalized to include those ranges of value, the return had to state the "executor's best estimate, rounded to the nearest $250,000." Temp. Reg. § 20.2010-2T(a)(7)(ii)(B).) The current instructions to IRS Form 706 provide that estimated values be rounded up to the nearest $250,000. *See* Instructions to Form 706 for decedents dying after December 31, 2012, p. 17.

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 adjustment under Section 1014, for purposes of preparing an accurate probate inventory, and perhaps for state estate tax purposes if there is a state estate tax. Various examples are provided in the regulations. Temp. Reg. § 20.2010-2T(a)(7)(ii)(C).

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

(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. (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 17 below.)

b) Computation of DSUE Amount.

(1) Statutory Provision. As mentioned above, prior to ATRA 2012, Section 2010(c)(4) of the Code seemed to limit the DSUE amount in the situation where a remarried spouse dies, thereby causing a potential "clawback" problem. In that case, when a person with a DSUE amount died, it appeared that the newly deceased spouse's available exemption was reduced by the amount of his or her taxable estate.

Based upon a literal reading of the statute, a problem occurred if the newly deceased spouse had made taxable gifts during his or her lifetime. As written, the statute required the decedent's "basic exclusion amount" to be reduced by the amount of the taxable estate, including those lifetime taxable gifts. 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 effect of this change is to increase the DSUE amount 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 before being treated as using his or her own basic exclusion amount.[5]

Example 4: H1 dies leaving an unused exclusion amount of $2 million. A portability election is made so that W's applicable exclusion amount is $7 million. After H1's death, W makes a taxable gift of $1.5 million. W marries H2. W then dies, survived by H2. 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, so that H2 receives a $5 million DSUE amount from W, instead of only a $3.5 million DSUE amount. 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 now concurs. A computation of the DSUE amount from W would start by subtracting her taxable gifts not from her basic exclusion amount, but from her basic exclusion amount *plus the DSUE amount from H1* (i.e., her applicable exclusion amount at the time of the gift). 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. The regulations clarify that if the decedent paid a gift tax on prior gifts, those gifts are excluded from the computation of the DSUE amount. This reaches a fair result.

Without the language in the regulations, under the literal statutory language, if an individual makes lifetime gifts in excess of the gift tax exclusion amount available at the time of the gift, the excess reduces the DSUE amount for that individual's surviving spouse, even though the individual had to pay gift tax. 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). Therefore, 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.

Example 5: While married to H1, W makes a taxable gift of $6 million, and pays gift tax on $1 million. H1 then dies leaving a $5 million DSUE amount to W. Under a literal reading of the statute, W's applicable exclusion amount would be $4 million (W's basic exclusion amount of $5 million, plus the DSUE amount of $5 million, less her adjusted taxable gifts of $6 million). But the regulations make clear that the amount of prior gifts on which W paid tax ($1 million) is not subtracted from her applicable exemption amount, and as a result, W's applicable exemption amount is $5 million.

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 regulations reserve 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

[5] See the discussion of using the DSUE amount from multiple deceased spouses—the "black widow" issue—beginning on page 8 below.

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 him or her, 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).

Example 6: W1 dies survived by H. W1's estate passes outright to H, and the executor of W1's estate makes a portability election. As a result, H receives W1's DSUE amount of $5 million. H then marries W2. H's applicable exclusion amount continues to be his basic exclusion amount plus the $5 million DSUE amount he inherited from W1. Later, H divorces W2, who then dies. Since W2's death occurred when she was not married to H, her death does not cause a loss of the DSUE amount H inherited from W1. This result suggests that tax benefits might be preserved for married persons with a DSUE amount received from a predeceased spouse, by obtaining a divorce from a terminally ill second spouse. This benefit would arise if the DSUE amount available from W2 is less than the unused amount received from W1.

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, so long as a portability election is properly and eventually made. 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 to elect 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 the DSUE amount if the new spouse predeceases her).

Example 7: W dies leaving her entire estate to H. Before an estate tax return is filed by the executor of W's estate, H makes a taxable gift of $7 million. If in fact a portability election is ultimately made on a timely filed estate tax return, H may apply his basic exclusion amount plus any DSUE amount received from W in order to shelter the gift from tax.

A word of caution: 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 an otherwise anticipated DSUE amount when the surviving spouse files a gift or estate tax return reporting the transfer. For example, if the executor never files an estate tax return making 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 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).[6]

Example 8: The facts are the same as in Example 7, except that despite H's understanding to the contrary, no portability election is made (or an election not to apply portability is made). As a result, H may use only his basic exclusion amount to offset the gift from tax. Likewise, if an election is made, but the DSUE amount received from W is substantially less than H anticipated, H's applicable exclusion amount may be insufficient to offset the tax on the gift.

e) Gifts by Surviving Spouse.

(1) Generally—DSUE Amount Included in Surviving Spouse's Applicable Exclusion Amount for Gift Tax Purposes. Subject to the portability

[6] The authors are puzzled by the quoted requirements. It is unclear how the surviving spouse might be able to substantiate the DSUE amount claimed on his or her gift tax return when the surviving spouse was not the executor filing the estate tax return on which the DSUE amount was computed. More troubling still is the requirement for a surviving spouse to substantiate a DSUE amount claimed on *his or her own* estate tax return!

election being made as described above, 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. For gift tax purposes, one's "last deceased spouse" is determined at the time of the gift. The DSUE amount from a spouse is used to determine the applicable exclusion amount with respect to a 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 a 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) 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." 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. Accordingly, if a surviving spouse wishes to make gifts to utilize the DSUE amount from a deceased spouse, the donor should consider making the gift as quickly as possible to assure that the DSUE amount from that particular last deceased spouse is utilized.

Example 9: W1 dies in January, leaving her entire estate to H. H marries W2 in February. In March, H makes a taxable gift of $7 million. W2 dies in June. If a portability election is ultimately made with regard to W1's estate on a timely filed estate tax return, H may apply his basic exclusion amount plus any DSUE amount received from W1 in order to shelter the gift from tax, since W1 was H's "last deceased spouse" at the time that the gift was made. If no portability election is made for W1's estate (or if an election to opt out of portability is made), then H may use only his basic exclusion amount to offset the gift from tax.

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).

Example 10: The facts are the same as in Example 9, except that no portability election is made for W1's estate, but a timely portability election is made for W2's estate in November, before the end of the calendar year. A literal reading of the statute suggests that H's applicable exclusion amount is measured at the end of the calendar year, which would imply that H could use the DSUE amount received from W2 to shelter the gift from tax. However, W2 was not H's "last deceased spouse" at the time H made the taxable gift of $7 million. Therefore, H may use neither W1's DSUE amount for this gift (since no portability election was made) nor W2's DSUE amount (since she was not his last deceased spouse at the time of the gift). H could use the DSUE amount acquired from W2 for later taxable gifts (or at the time of his death).

(3) Ordering Rule. The regulations include a favorable ordering rule as well, 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. Without the ordering rule, 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 applicable exclusion 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. 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 (or at the time of a 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).

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 has a new last deceased 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 11: H1 dies with $5 million of unused exemption. W makes a gift of $10 million after H1 dies, all covered by her gift tax applicable exemption amount (which includes her basic exclusion amount plus the DSUE amount from H1). W then marries H2 (who is poor and in poor health) who also predeceases W. The executor of H2's estate makes a portability election, providing her with a DSUE amount of $5 million. Can W make another $5 million gift without paying gift tax? Because of the regulations, yes! If W makes another $5 million gift, this second gift is entirely sheltered by W's applicable exemption, since her remaining basic exclusion amount ($0), plus the DSUE amount received from H2 ($5 million) is $5 million.

Example 12: Consider the same facts in Example 11, but assume that W made only a $5 million gift before marrying H2. The ordering rule of the regulations apply to allocate H1's DSUE amount against that $5 million gift. Thereafter, W marries H2 and he dies. The executor of H2's estate makes a portability election, providing her with a DSUE amount of $5 million. Can W make another $5 million gift without paying gift tax? Again, because of the special rule in the regulations, yes! If W then makes another $5 million gift, the ordering rules of the regulations apply to allocate H2's DSUE amount against that $5 million gift. W then marries H3, whom she predeceases. Since all of W's $10 million in taxable gifts were sheltered by DSUE amounts, her entire basic exclusion amount remains available to be ported to H3, and added as a part of his applicable exemption.

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, the executor of that decedent's 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 does make sense. 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 because the individual would then be 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).

Example 13: H, a U.S. citizen, made a taxable gift in 2002, valued at $1 million, and reported the gift on a timely-filed gift tax return. No gift tax was due because the applicable gift tax exclusion amount for that year ($1 million) equaled the fair market value of the gift. H died in 2011 with a gross estate of $2 million. H's will made a pecuniary bequest of $1.5 million to a QDOT for the benefit of W, who was not a U.S. citizen. H's executor timely filed an estate tax return and made the QDOT election for the property passing to the QDOT. As a result, H's estate was allowed a marital deduction of $1.5 million for the value of that property. H's taxable estate is $500,000. On H's estate tax return, H's executor computes H's preliminary DSUE amount to be $3.5 million (the excess of H's $5 million applicable exclusion amount over the sum of the $500,000 taxable estate and the $1 million adjusted taxable gifts). No taxable events within the meaning of Code Section 2056A occurred during W's lifetime with respect to the QDOT, and W made no taxable gifts. In 2012, W dies and the value of the assets of the QDOT is $1,800,000. H's DSUE amount is redetermined to be $1.7 million (the lesser of (i) the $5 million basic exclusion amount in 2011, or (ii) the excess of H's $5 million applicable exclusion amount over $3.3 million (the sum of the $500,000 taxable estate augmented by the $1.8 million of QDOT assets and the $1 million adjusted taxable gifts)).

Example 14: H, a U.S. citizen, dies in Jan. 2011 having made no taxable gifts during his lifetime. H's gross estate is $3 million. H's wife W is a U.S. resident but not a U.S. citizen. Under H's will, a pecuniary bequest of $2 million passes to a QDOT for the benefit of W. H's executor timely files an estate tax return and makes the QDOT election for the property passing to the QDOT. As a result, H's estate is allowed a marital deduction of $2 million for the value of that property. H's taxable estate is $1 million. On H's estate tax return, H's executor computes H's preliminary DSUE amount to be $4 million. No taxable events occur during W's lifetime with respect to the QDOT. W makes a taxable gift of $1 million to her child in Dec. 2011 and another taxable gift of $1 million to her child in Jan. 2012. W dies in Sept. 2012, not having married again, when the value of the assets of the QDOT is $2.2 million. H's DSUE amount is redetermined to be $1.8 million (the lesser of (i) the $5 million basic exclusion amount in 2011, or (ii) the excess of H's $5 million applicable exclusion amount over $3.2 million (the sum of the $1 million taxable estate augmented by the $2.2 million of QDOT assets)). On W's gift tax return filed for 2011, W cannot apply any DSUE amount to her gift. However, because W's 2012 taxable gift was made in the year that W died, W's executor will be allowed to apply $1 million of H's redetermined DSUE amount to the gift on W's gift tax return filed for 2012. The remaining $800,000 of H's redetermined DSUE amount is included in W's applicable exclusion amount to be used in computing W's estate tax liability.

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).

Example 15: An estate tax return is timely filed for H's estate reflecting an estate of $4.9 million, all of which passes to a trust for W for which a QTIP election is made. The return is filed on March 1, 2014 making the portability election. W dies in 2019, and her estate tax return reflects the DSUE amount shown on H's estate tax return. In the course of examining W's estate tax return, the IRS determines that (i) the value of H's estate was actually $6.5 million; and (ii) the trust for W was ineligible for the QTIP election. Although the

statute of limitations for H's estate tax return precludes the IRS from collecting any estate tax as a result of H's death, the IRS may nevertheless eliminate the DSUE amount claimed to be available by W's executor.

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

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

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

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

3. No Shelter of Growth. Assets passing to the bypass trust are exempt from estate tax at the surviving spouse's death regardless of the value of those assets at that time. Thus, a spouse could pass up to $5 million worth of property ($5.34 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 surviving spouse's death.

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

5. Possible Loss upon Remarriage. The surviving spouse is entitled to use the unused estate tax exemption only of the most recently deceased spouse. IRC § 2010(c)(4)(B)(i). If the surviving spouse remarries, and the new spouse then dies, that spouse (who may have a substantial estate, or for whose estate an estate tax return is not filed to 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.

E. Use with Bypass Trusts—It's Not "Either/Or." Don't forget that bypass trust planning and portability are not "either/or" propositions. Even if the decedent's Will or revocable trust 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.

Example 16: H dies in 2011 with an estate of $4 million which passes to a bypass trust for W. A portability election is made passing H's remaining $1 DSUE amount to W, who has her own $4 million estate. During the next nine years, the estate grows at 6% per year, while inflation is only 3% per year. W dies at the end of 9 years. At that time, her estate has grown to about $6.75 million, while her basic exclusion has grown to only about $6.5 million. If no portability election had been made, her estate would owe about $100,000 in tax. But since the portability election was made, W's estate may utilize not only her $6.5 million (inflation-adjusted) basic exclusion amount, but also the $1 million DSUE amount from H's estate, thereby eliminating the estate tax.

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

III. A NEW ESTATE PLANNING PARADIGM

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

A. Using Bypass Trusts.

1. Basis Adjustment at Second Death. For years, estate planners have designed bypass trusts with the express goal of excluding those assets from the taxable estate of the surviving spouse for estate tax purposes. While estate taxes were avoided, so too was a cost basis adjustment in those assets upon the death of the surviving spouse.

Example 17: H and W have a community property estate of $6 million (or simply two relatively equal estates totaling $6 million). H dies with a Will that creates a traditional bypass trust for W. W outlives H by 10 years. Over that time, the trustee distributes all of the bypass trust's income to W, but the fair market value of the trust's assets has doubled to $6 million. Meanwhile, W has retained her own $3 million in assets, which have held their value at $3 million. At the time of W's death, no estate will be due on her $3 million estate. The assets in the bypass trust will not be included in her estate for federal estate tax purposes, so they will not receive a new cost basis at the time of her death. As a result, their children will inherit assets in the bypass trust with a value of $6 million, but with a basis of only $3. If instead, H had left the property outright to W, and if H's executor had filed an estate tax return electing portability, no estate tax would be owed on W's $9 million estate. Had H left his assets to W outright (or to a differently designed trust), the children would have received a new cost basis of $6 million in the assets passing from H to W, potentially saving them $714,000 in taxes ($3,000,000 x 23.6%).[7]

2. Higher Ongoing Income Tax Rates. Single individuals are subject to the highest income tax rates on income in excess of $400,000, and are subject to the tax on net investment income if their income exceeds $200,000. IRC §§ 1, 1411. In contrast, income not distributed from a trust is taxed at the top income tax rate to the extent it exceeds $12,150 (for 2014), and is subject to the net investment income tax if its undistributed net investment income exceeds that amount *Id.* Therefore, under the foregoing example, unless the wife's taxable income would otherwise exceed $400,000 ($450,000 if she remarries and files jointly) any taxable income accumulated in the bypass trust will be taxed at a higher income tax rate than it would if no trust had been used. Including the tax on undistributed net investment income, the trust's tax rate might be 43.4% for short term capital gains and ordinary income and 23.8% for long term capital gains and qualified dividends. Contrast these rates to rates of only 28% and 15% respectively if the wife's taxable income were between $127,550 and $200,000.

3. Some Assets Cause Greater Tax Burdens. A client's asset mix may impact the importance of these issues. For example, assets such as IRAs, qualified

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

plans, and deferred compensation, may give rise to ordinary income taxes, without regard to their basis. Retirement plan assets left outright to a spouse are eligible to be rolled over into the spouse's name, which may make them eligible for additional income tax deferral than if they passed into a bypass or other trust. A personal residence may be eligible to have all or a portion of any capital gains tax recognized on its sale excluded from income if owned outright. IRC § 121(a). The exclusion is not available to the extent that the residence is owned by a non-grantor trust. *See* TAM 200104005. Some types of business entities (notably, S corporations) require special provisions in the trust to ensure that they are eligible to be treated as "Qualified Subchapter S Trusts" or "Electing Small Business Trusts." If these provisions are omitted or overlooked during the administration of the trust, substantially higher taxes may result to all shareholders of the entity.[8]

Example 18: H has an IRA worth $1 million which earns 6% per year, the beneficiary of which is the trustee of a bypass trust for W. H dies when W is 60 years old. Because the IRA is payable to the trust, W cannot role the IRA over into her own IRA. Instead, she must begin to take minimum required distributions in the year following H's death, based upon her single life expectancy. If instead, the IRA had been payable to W, she could have rolled the IRA over to her own IRA, deferred minimum required distributions until age 70 ½, and used the more favorable unified table for her life expectancy. If W lives to age 90 taking only minimum required distributions, then in either event, W would receive about $1.4 million after tax from the IRA. Since the IRA was payable to the bypass trust, it would then hold about $2.75 million. If instead, the IRA had been payable to W, the ability to defer distributions for an additional 10 years would mean that the IRA would hold nearly $4 million!

4. Disclaimer Bypass Trusts. With proper advanced drafting, married couples can structure their Wills or revocable trusts to allow the surviving spouse to take a "second look" at their financial and tax picture when the first spouse passes away. If the total combined estates will be less than the applicable exclusion amount (including any DSUE amount) then the survivor can accept an outright bequest of assets, and if desired, the executor can file an estate tax return making the DSUE election. If the total value of the estate is expected to exceed the applicable exclusion amount, then the surviving spouse can disclaim all or any part of the inheritance. Language in the Will or revocable trust could provide that the disclaimed amount passes into the bypass trust. In order for the disclaimer to be effective, it must comply with the technical requirements of local law and the Internal Revenue Code. *See, e.g.,* TEX. ESTS. CODE Chpt. 122; IRC § 2518. The disclaimer must be filed within nine months of the date of death *and* before any benefits of the disclaimed property are accepted. The disclaimed property must generally pass in a manner so that the disclaiming party will not benefit from the property. An important exception to this rule, however, permits the surviving spouse to disclaim property and still be a beneficiary of a trust, including a bypass trust, to which the disclaimed property passes. IRC § 2518(b)(4)(A). More troubling is the requirement that the disclaimed property must pass without direction or control of the disclaiming party. This requirement generally prevents (or at least greatly restricts) the surviving spouse from retaining a testamentary power of appointment over the bypass trust to which assets pass by disclaimer. *See* Treas. Reg. § 25.2518-2(e)(1)(i); Treas. Reg. § 25.2518-2(e)(5), Exs. (4)-(5).

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

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

2. Creditor Protection. If an inheritance passes outright and free of trust, the property will be subject to attachment by outside creditors unless the property is otherwise exempt from attachment under local law (in

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

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

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

4. Protection of Governmental Benefits. If the surviving spouse is eligible (or may become eligible) for needs-based government benefits (e.g. Medicaid), a bypass or other trust may be structured to accommodate eligibility planning. An outright bequest to the spouse may prevent the spouse from claiming those benefits.

5. Protection from State Inheritance Taxes. Assets left outright may be included in the beneficiary's taxable estate for purposes of state estate or inheritance tax. While the inheritance tax in many states has been repealed or is inoperable so long as there is no federal estate tax credit for state death taxes paid, there can be no assurance that the beneficiary will reside (or remain) in one of those states. The potential exposure depends upon the exemptions and rates applicable at the time of the beneficiary's death, but the applicable taxes can be surprisingly high. (*See, e.g.,* Washington State's RCW 83.100.040 (2013) imposing a 20% state estate tax on estates exceeding $2 million in value).

6. Income Shifting. If permitted, income earned by a trust can be distributed to trust beneficiaries, who may be in lower income tax brackets than the surviving spouse or the trust. IRC §§ 651, 662. Income from assets left outright cannot be "sprinkled" or "sprayed" to beneficiaries in lower tax brackets, which for many families can lower the overall family income tax bill.

7. Shifting Wealth to Other Family Members. While a surviving spouse might make gifts of his or her assets to children, elderly parents, or other family members, those gifts use up the spouse's gift and estate tax exemption to the extent that they exceed the gift tax annual exclusion. If assets are held in a bypass trust, and if the trust permits distributions to other family members, the amounts distributed to them are not treated as gifts by the surviving spouse, and do not use the spouse's gift or estate tax exemption or annual exclusion, regardless of their amount.

8. No Inflation Adjustment. The DSUE amount, once set, is not indexed for inflation, whereas the surviving spouse's basic exclusion amount (the $5 million) is adjusted beginning in 2012 for inflation after 2010 ($5.34 million in 2014). In addition, if assets are inherited in a bypass trust, any increase in the value of those assets remains outside the surviving spouse's estate. The importance of this feature increases: (i) as the value of a couple's net worth approaches $10 million; (ii) if asset values are expected to increase rapidly; and (iii) if the surviving spouse may be expected to outlive the decedent by many years.

Example 19: H dies in 2011 with a $4 million estate. His Will leaves everything to W, and a portability election is made. W has her own estate, also worth $4 million. During the next nine years, the estate grows at 6% per year, while inflation is only 3% per year. W dies at the end of 9 years. At that time, her estate (plus the amount she inherited from H) has grown to about $13.5 million, while her basic exclusion has grown to only about $6.5 million. When combined with the $5 million DSUE amount received from H, her applicable exemption amount is $11.5 million, resulting in federal estate taxes of about $800,000. If instead, H's $4 million estate had passed into a bypass trust for W, W's basic exclusion of $6.5 million plus her DSUE amount of $1 million would exceed her $6.75 million estate. Instead of paying $800,000 in estate tax, no estate tax would be due on her estate, and no estate tax would be paid on the $6.75 million owned by the bypass trust.

9. Risk of Loss of DSUE Amount. The surviving spouse is entitled to use the unused estate tax exemption only of the most recently deceased spouse. IRC § 2010(c)(4)(B)(i). If the surviving spouse remarries, and the new spouse then dies, the new spouse (who may have a substantial estate, or for whose estate an estate tax return may not be filed to pass along any DSUE amount), becomes the last deceased spouse. Unless the surviving spouse makes taxable gifts before the new spouse's death (thereby using the DSUE amount of the first deceased spouse), any unused exemption of the first spouse to die is then lost. If no DSUE amount is acquired from the new last

deceased spouse, the cost to the family could be $2.1 million or more in additional estate tax (40% of $5.34 million). This risk does not apply if assets are inherited in a bypass trust.

Example 20: W1 dies in 2011, leaving her entire estate to H, and a portability election is made with regard to W1's estate on a timely filed estate tax return. H marries W2 in 2014. W2 dies in 2015 leaving her sizable estate to the children of her first marriage. As a result, no DSUE amount is available to H with regard to W2's estate. Since W2 is now H's "last deceased spouse," H has no DSUE amount. The DSUE amount formerly available from W1 is lost.

10. No DSUE Amount for GST Tax Purposes. There is no "portability" of the GST tax exemption. In 2014, a couple using a bypass trust can exempt $10.68 million or more from both estate and GST tax, if not forever then at least a long as the Rule Against Perpetuities allows. A couple relying only on portability can only utilize the GST tax exemption of the surviving spouse ($5.34 million in 2014).

Example 21: Assume the same facts as in Example 19. If portability is used, only $12.7 million after tax is left to pass to trusts for children. W may shelter only $6.5 million of that amount from GST tax, since only her (inflation-adjusted) exemption is available to allocate to the children's trusts. The balance ($6.2 million) will not be exempt from GST tax, and will likely be taxed in the estate of the children. If instead, H's estate had passed into a bypass trust, H's GST exemption could have been allocated to the bypass trust, and the exemption would have continued on in trusts for children. In addition, W could allocate her GST tax exemption to shelter almost all of her $6.75 million after-tax estate. Not only would the children inherit $800,000 more, but virtually all of the inheritance could pass to them in GST tax-exempt trusts.

Efficient use of a couple's GST tax exemption may be more important if the couple has fewer children among whom to divide the estate, especially when those children are successful in their own right.

Example 22: H and W, a married couple with a $10 million estate, leave everything outright to their only child C. As a result, C immediately has a taxable estate. If instead, after leaving everything to each other (using portability), the survivor leaves assets to a lifetime trust for C, only about half of the estate can pass into a GST tax-exempt trust, using the surviving spouse's GST tax exemption. The balance will pass into a non-exempt trust for C (usually with a general power of appointment), which can lead to an additional $5 million (plus growth) added to C's estate. If the first spouse's estate had passed into a bypass trust (or, as discussed below, into a QTIP trust for which a "reverse" QTIP election was made for GST tax purposes), the entire $10 million could pass into a GST tax-exempt trust for C, completely avoiding estate tax at the time of C's death.

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

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

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

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

3. New Cost Basis at Second Spouse's Death. If a QTIP election is made under Section 2056(b)(7)(v) of the Code, then upon the death of the surviving spouse, the assets in the QTIP trust are treated for basis purposes as though they passed from the surviving

spouse at the second death. IRC § 1014(b)(10). As a result, they are eligible for a basis adjustment at the death of the surviving spouse.

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

5. QTIPs and Portability. From an estate tax standpoint, making the QTIP election means that the assets passing to the QTIP trust will be deductible from the taxable estate of the first spouse, thereby increasing the DSUE amount available to pass to the surviving spouse. IRC § 20256(b)(7). (*But see* the discussion of Revenue Procedure 2001-38 at page 17 below.) Of course, the assets on hand in the QTIP trust at the time of the surviving spouse's death will be subject to estate tax at that time as though they were part of the surviving spouse's estate. IRC § 2044. But if the surviving spouse's estate plus the QTIP assets are less than the surviving spouse's $5.34 million basic exclusion amount (or if a portability election has been made, less than the surviving spouse's applicable exclusion amount) then no estate tax will be due.

6. QTIPs and Using the DSUE Amount. As discussed above, one strategy that a surviving spouse might consider, especially if remarriage is a possibility, is to make a taxable gift prior to remarriage (or at least prior to the death of a new spouse) to be sure to capture the DSUE amount of the prior spouse. If the spouse is a beneficiary of a QTIP trust, one possible form of that gift would be to intentionally trigger a gift of the QTIP trust assets under Section 2519 of the Code. Section 2519 provides that if a surviving spouse releases any interest in a QTIP trust, transfer taxes are assessed as though the entire QTIP trust (other than the income interest) had been transferred. If the surviving spouse were to release a very small interest in the QTIP trust, the result would effectively be to make a gift of the entire QTIP, thereby using DSUE amount, even though the surviving spouse would retain the use of the unreleased income interest. By making a gift of the QTIP trust while retaining the income interest, the trust assets will be included in the surviving spouse's estate at death, thereby receiving a new cost basis. IRC § 1014(b)(4). Moreover, because estate tax inclusion arises under Code Section 2036 and not Section 2044, a corresponding adjustment will be made to the surviving spouse's computation of adjusted taxable gifts at death. *See* Treas. Reg. § 20.2044-1, Ex. 5.[9]

Example 23: W has a $5 million estate. W dies with a Will leaving all to a QTIP trust for H. W's executor files an estate tax return making both the QTIP and the portability elections. Immediately thereafter, H releases 0.5% of the income interest in the QTIP trust assets. The release of the income interest is a taxable gift of the 0.5% interest under Section 2511 of the Code, but more importantly, the release also constitutes a gift of the balance of the trust assets under Code Section 2519. Because the interest retained by H is not a qualified annuity interest, Code Section 2702 precludes any discounts on valuing that interest. The effect is for H to have made a $5 million gift, all of which is sheltered by W's DSUE amount. Even though the DSUE amount has been used, H still retains 99.5% of the income from the QTIP trust for life. In addition, the QTIP trust assets are included in H's estate under Code Section 2036, so a new cost basis will be determined for the assets when H dies. Because the assets are not included in the estate under Section 2044 of the Code, the taxable gift will not be treated as an adjusted taxable gift when H dies.

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

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

2. Estate Tax Exposure. Presumably, the QTIP trust has been used in order to achieve a step-up in basis in the inherited assets upon the death of the

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

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

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

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

An executor must file an estate tax return to elect portability, even if the return is not otherwise required to be filed for estate tax purposes. In that case, a QTIP election is not required to reduce the federal estate tax, because there will be no estate tax in any event. However, a QTIP election might still be made to maximize the DSUE amount, gain a second basis adjustment at the death of the surviving spouse, and support a reverse-QTIP election for GST tax purposes. Does Revenue Procedure 2001-38 mean that 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. The Revenue Procedure itself, however, suggests that it may be invoked by "produc[ing] a copy of the estate tax return filed by the predeceased spouse's estate establishing that the election was not necessary to reduce the estate tax liability to zero." When a DSUE amount is utilized, the return on which portability was elected will need to be produced, and any return filed only to elect portability will necessarily show that the QTIP election was not necessary to reduce estate tax. Granted, to obtain relief, the Revenue Procedure also states that "an explanation of why the election should be treated as void" should be included with the return, suggesting that to be treated as void, the taxpayer needs to take affirmative action to request it.

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

5. *Clayton* QTIP Trusts. When the statute authorizing QTIP trusts was first enacted, the IRS strictly construed language in Section 2056(b)(7)

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

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

6. The QTIP Tax Apportionment Trap. Remember that if estate tax ultimately proves to be due as a result of having made the QTIP election, the source of payment for these taxes becomes important. Under federal law, except to the extent that the surviving spouse in his or her Will (or a revocable trust) specifically indicates an intent to waive any right of recovery, the marginal tax caused by inclusion of the QTIP assets in the surviving spouse's estate is recoverable from the assets of the QTIP trust. IRC § 2207A(1). Many state tax apportionment statutes adopt this rule, either expressly or by reference. *See, e.g.,* TEX. ESTS. CODE § 124.003. When the beneficiaries of the surviving spouse's estate and the remainder beneficiaries of the QTIP trust are the same persons, this rule generally makes little difference. Where they differ, however, the result could be dramatic, and highlights the need to check the "boilerplate" of clients' Wills. Consider the following example:

Example 24: H & W each have a $10 million estate. H dies with a Will leaving all to a QTIP trust for W, with the remainder interest in the trust passing upon W's death to his children from a prior marriage. H's executor files an estate tax return making both the QTIP and the portability elections. W immediately thereafter, knowing she can live from the QTIP trust income, makes a gift of her entire $10 million estate to her children. No gift tax is due since W can apply her applicable exclusion amount to eliminate the tax. Upon W's later death, the remaining QTIP trust assets are subject to estate tax under Section 2044 of the Code. Since W used all of her applicable exclusion amount to shelter her gift to her children, none of her exemption (or a nominal amount because of the inflation adjustment of her basic exclusion amount) is available to shelter estate tax, and the entire $10 million (assuming no changes in value) is taxed. All of this tax is attributable to the QTIP trust assets, so unless W's Will expressly provides otherwise, the estate tax liability of $4 million is charged to the trust (and therefore, in effect, to H's children). As a result, H's children are left with $6 million from the remainder of the QTIP assets, while W's children receive $10 million tax free.

One solution to this problem may be to have H's executor agree to the portability election only if W (i) agrees to waive estate tax recovery under Section 2207A except to the extent of pro rata taxes (instead of

marginal taxes); and (ii) agrees to retain sufficient assets to pay applicable estate taxes associated with her property transfers, whether during lifetime or at death. As one might imagine, drafting such an agreement would not be a trivial matter.

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

1. Structure of LEPA Trusts. Section 2056(b)(5) of the Code permits a marital deduction for property passing into trust for a spouse so long as the surviving spouse is entitled for life to the income from all or a specific portion of the trust, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the trust property (exercisable in favor of the surviving spouse or the estate of the surviving spouse, or in favor of either, whether or not the power is exercisable in favor of others), so long as no power is given to anyone to appoint any part of the trust to anyone other than the surviving spouse. This so-called Life Estate Power of Appointment ("LEPA") trust thereby allows a marital deduction without many of the other restrictions applicable to QTIP trusts. Note that the spouse may be given the right to income from all of the trust (or a specific portion of the trust determined on a fractional or percentage basis) that is intended to qualify. The power of appointment must be exercisable by the spouse alone, and may be inter vivos or testamentary, as long as it is exercisable over all of the trust property from which the spouse has a right to the income. IRC § 2056(b)(5), (10).

2. Benefits of LEPA Trusts. Since the advent of QTIP trusts, estate planners have generally preferred them, since they allow the creator of the trust to restrict the disposition of any trust property remaining at second death, by restricting or even eliminating the surviving spouse's power to appoint the trust property. However, LEPA trusts do cause inclusion in the surviving spouse's estate, thereby providing a basis adjustment in the trust's assets at the death of the surviving spouse. IRC § 1014(b)(4). In addition, they provide many of the other trust benefits such as creditor protection and divorce protection, as well as management assistance through the use of a trustee or co-trustee other than the spouse. While neither the income nor the associated tax liability of a LEPA may be shifted to others, a LEPA may avoid application of compressed tax rates if the surviving spouse has a general power to appoint property to him- or herself during lifetime. IRC § 678. Especially in smaller estates of couples with children of the same marriage, and in states with no state estate tax, the LEPA trust may see a rise in popularity because couples with smaller estates don't need to file an estate tax return to get the second basis adjustment. The LEPA trust may also be preferred by estate planning advisors that fear that the IRS won't favorably resolve the risk to using QTIP trusts and portability posed by Revenue Procedure 2001-38, discussed above at page 17.

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

IV. ADDRESSING INCOME TAX ISSUES

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

A. Creative Options to Create Basis. Estate planners have suggested a number of other tools that could be brought to bear on the drawbacks presented by bypass trusts. Each of these options have advantages and disadvantages, and it appears that there may be no "one-size-fits-all" (or "even one-size-fits-most") solution to the problem.

1. Distribution of Low-Basis Assets. Perhaps the most straight-forward approach involves simply having the trustee 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 exclusion amount. If the distribution can be justified as having been made for the spouse's health, education, maintenance or support (or however the trust's applicable distribution standard reads), then arguably, this distribution could be undertaken with no other special language in the governing instrument. So long as the spouse passes these assets at death to the same person(s) who would have received them from the bypass trust, there is presumably no one to complain. The remaindermen receive the assets with a higher cost basis, so they are actually better off than if the distribution had never been made. This approach has its shortcomings. For example: (i) the trustee must identify the low-basis assets and distribute them to the spouse in the proper amount, presumably shortly before the spouse passes away; (ii) if the surviving spouse dies with substantial creditors or changes his or her dispositive plan before death, the remaindermen may be injured by the distribution (for which the trustee could presumably be liable if it can be shown that the distribution was not made pursuant to the applicable distribution standard); and (iii) if the surviving spouse truly has no need for the distribution, the IRS might argue that the distribution was unauthorized, asserting that a constructive trust was thereby imposed for the remainder beneficiaries, effectively excluding the assets from the spouse's estate (and precluding any step-up in basis). *See Stansbury v. U.S.,* 543 F Supp 154, 50 AFTR 2d 82-6134 (ND Ill 1982), aff'd 735 F2d 1367 (7th Cir. 1984) (holding, in an entirely different context, that assets subject to a constructive trust were excluded from the estate of the nominal owner for estate tax purposes).

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

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

3. Giving a Third Party the Power to Grant a General Power of Appointment. A related technique advocates giving an independent trustee or trust protector not the distribution authority directly, but rather the power to grant to the surviving spouse (or others) a general testamentary power of appointment. The idea is that if it is apparent that no estate tax will be due upon the survivor's death, the power could be exercised to grant the spouse a general power, and thereby achieve a basis adjustment. This approach might protect the trust assets from creditors during the surviving spouse's lifetime, but it suffers from many of the same shortcomings as the technique just described. In particular, (i) it must have been included in the governing instrument; (ii) a person (or persons) willing and able to hold this power must be identified; (iii) the person must be willing to exercise the authority at the

right time; and (iv) the surviving spouse might actually exercise the power and divert the assets outside the family. Any person given this authority must be concerned about being held liable by the trust's remaindermen for improvidently exercising (or failing to exercise) the power, or by the spouse if the power is exercised at a time when the spouse is expected to die but doesn't. More problematic is the concern that under Code Section 2041(b)(1)(C)(iii) a general power of appointment that is exercisable in conjunction with another person is nevertheless a general power if the other person does not have an adverse interest, and it is a general power as to the entire value of the trust property if the other person is not a permissible appointee. A trust protector would typically not have an adverse interest or be a permissible appointee. At least one commentator[10] has questioned whether there is no real difference between a power that is conferred by the protector and a power held jointly with the protector. If the IRS views them as the same, then the surviving spouse (in this example) would be deemed to hold a general power over *all of the trust assets* in all events, regardless of the size of the estate and *regardless of whether the protector exercised the authority to grant the power*.

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

5. Decanting the Bypass Trust to a Trust that Provides Basis. If the bypass trust does not by its terms contain provisions that would allow a basis adjustment at the death of the surviving spouse, some commentators have suggested that the trust be modified or decanted into a trust that has more favorable terms. While the intricacies of trust modifications and decanting are well beyond the scope of this paper, one need only note that this form of decanting may not be available in all jurisdictions. For example, under the current Texas decanting statute, no change may be made to the dispositive (as opposed to administrative) provisions of a trust via decanting unless the trustee's power to make distributions is not limited in any way. *See generally* TEX. PROP. CODE § 112.073 (stating the law governing distribution of property in a second trust when the trustee has limited discretion). It isn't merely a "health, education, maintenance and support" standard that causes a trustee's powers to be limited in Texas. Rather, literally any restriction on trustee powers imposes these limits. *See* TEX. PROP. CODE § 112.072(a). In addition, even if a trustee has unlimited discretion (a true rarity, and one which would seem to obviate the need to decant to achieve the aims discussed above), under current Texas law, no decanting may occur if it will "materially impair the rights of any beneficiary." TEX. PROP. CODE § 112.085(2). Decanting to a trust that grants a spouse broad powers of appointment might "materially impair" the rights of remainder beneficiaries. Finally, no matter the state involved, a trustee's power to decant is subject to the trustee's overall fiduciary duties, and may have tax consequences apart from achieving the basis aims discussed here. For a thorough discussion of decanting generally, s*ee* Willms, "Decanting Trusts: Irrevocable, Not Unchangeable," 6 EST. PLAN. & COMMUNITY PROP. L. J. 35 (2013).[11]

6. Making a Late QTIP Election. If the bypass trust happens to otherwise qualify as a QTIP trust, and no federal estate tax return was ever filed to not make a QTIP election, it may be possible to file an estate tax

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

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

return to make a late QTIP election. Although somewhat rare, some bypass trusts qualify for QTIP treatment with a proper election. Specifically, the bypass trust must provide that the surviving spouse is the sole beneficiary during his or her lifetime, is entitled to demand or receive all net income at least annually, and can require unproductive property be made productive. Somewhat surprisingly, a QTIP election can be made on the last timely filed estate tax return, or, *if no return is filed on time, on the first late-filed return*. Treas. Reg. § 20.2056(b)-7(b)(4)(i). That means that long after the fact (conceivably, even after the death of the surviving spouse) a return could be filed that relates back to the time of the first spouse's death, thereby causing the trust assets to be included in the surviving spouse's estate and resulting in basis adjustment in the trust's assets at the second death. Note that it is unlikely that anything like surgical precision would be possible in this circumstance. Although partial QTIP elections are permitted, it is unlikely that the election could be made only as to those assets whose values increased between the first and second death. *See* Treas. Reg. § 20.2056(b)-7(b)(3).

B. The Optimal Basis Increase Trust ("OBIT"). In an ideal world, estate planners would design a trust that ensures that upon the surviving spouse's death, its assets get a step-up, but not a step-down in basis, doesn't generate any federal estate tax (or any extra state estate tax), achieves better ongoing income tax savings than a typical bypass or marital trust, and preserves asset protection benefits, all without the drawbacks described above. One approach to such a trust has been suggested by attorney Edwin P. Morrow, III who describes employing a combination of techniques with a bypass/marital trust plan to create what he refers to as an "Optimal Basis Increase Trust" or "OBIT."[12] The key feature of this plan is to make creative use of testamentary general and limited powers of appointment to (i) assure that assets in the trust receive a step-up in basis, but never a step-*down* in basis; and (ii) dynamically define or invoke these powers so as to not cause additional estate tax.

1. Granting a General Power of Appointment to Obtain Basis. As part of a traditional bypass trust, an OBIT might grant the surviving spouse a testamentary limited power of appointment (or no power at all) over all IRD assets (which cannot receive a new cost basis) and over assets with a basis higher than the fair market value at the time of the surviving spouse's death (for which no new basis is desired). However, it would grant the surviving spouse a general testamentary power of appointment ("GPOA") over any assets that have a fair market value greater than their tax basis.[13] Such a "split" power of appointment would assure that appreciated assets in the trust would receive a step-up in basis, but no assets would receive a step-down.

2. Applying a Formula to Avoid Estate Tax. What if the value of the appreciated assets in the bypass trust, when added to the value of the surviving spouse's estate, exceeds the surviving spouse applicable exclusion amount at the time of his or her death? In that event, basis would be acquired, but at the cost of paying estate tax. One alternative is to restrict the surviving spouse's GPOA by a formula. The formula would, in effect, provide that the GPOA is only applicable to those trust assets to the extent it does not cause increased federal estate tax. (As a further refinement, the formula might also take into account state estate tax, if it is potentially applicable). Estate planners have been drafting formula powers of appointment for years (usually in the context of avoiding GST taxes) which limit the scope of the GPOA either as to appointees or assets. There is no reason one cannot grant a general power of appointment over less than 100% of trust assets, or by formula. *See* Treas. Reg. § 20.2041-1(b)(3). In fact, one might further fine-tune the formula to limit its application first to those assets with the greatest embedded gain (or those assets whose sale would result in the most federal income tax, taking into consideration not only the amount but the character of the gain involved). In this regard, the drafting difficulty arises not so much with describing the upper limit on the GPOA, but in creating an ordering rule which appropriately adjusts the formula based upon the circumstances that one might reasonably expect to be applicable at the death of the surviving spouse.[14]

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

[13] As discussed below, this targeted estate tax inclusion and resulting basis adjustment may also be accomplished by granting the surviving spouse a limited power of appointment that is exercised in a manner to trigger the Delaware Tax Trap.

[14] Morrow notes:

> Assets that may incur higher tax rates, such as collectibles . . . would be natural candidates for preference. On the opposite end of the spectrum, other assets might have lower tax rates or exclusions, such as qualifying small business stock or a residence that a beneficiary might move into, but those would be relatively rare situations. Most families would prefer the basis go to depreciable property, which can offset current

3. Designing the Formula. In its simplest form, the formula GPOA might apply to a pecuniary amount rather than to specific assets. However, funding such a pecuniary amount would require the trustee to determine the assets over which it applies. That discretion would likely result in undesired income tax consequences. In particular, distributions that satisfy a pecuniary obligation of the trust are recognition events for the trust. The fair market value of the property is treated as being received by the trust as a result of the distribution; therefore, the trust will recognize any gain or loss if the trust's basis in the property is different from its fair market value at the time of distribution. Rev. Rul. 74-178, 1974-1 CB 196. Thus, gains or losses will be recognized by the trust if the formula gift describes a pecuniary amount to be satisfied with date-of-distribution values, as opposed to describing specific trust assets or a fractional share of the trust. *See* Treas. Reg. § 1.661(a)-2(f)(1); Treas. Reg. § 1.1014-4(a)(3); Rev. Rul. 60-87, 1960 1 CB 286. As a result, one should avoid simple powers of appointment over, for example, "assets with a value equal to my [spouse's] remaining applicable exclusion amount."

On the other hand, if the surviving spouse's testamentary power potentially extends to all of the applicable property equally, but is fractionally limited, all property subject to that provision should get a fractional adjustment to basis. A pro rata adjustment would result in wasted basis adjustments, since a $1,000,000 asset with $1 gain would use just as much of the surviving spouse's applicable exclusion amount as a $1,000,000 asset with $900,000 gain. The result would be better than no extra basis at all, but not as optimal as the trustee limiting the surviving spouse's GPOA, or establishing an ordering rule to determine exactly which property the power pertains to.[15]

income, before allocating to stocks, bonds, raw land, family vacation home, etc. Therefore, ultimately a weighting may be optimal, or even a formula based on tax impact, but at the most basic level practitioners would want the GPOA to apply to the most appreciated assets first.

See Morrow, fn. 12, at pp. 21-22.

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

By specifying that the GPOA applies on an asset-by-asset basis to the most appreciated asset first, cascading to each next individual asset until the optimal amount is reached, the difficulty with pecuniary funding can likely be avoided. Since the ordering formula necessarily means that the GPOA could never apply to depreciated assets, the IRS would have no statutory basis to include them in the surviving spouse's estate (or accord them an adjusted basis). The GPOA would apply to specific property, and not a dollar amount or a fraction. Applying the formula would likely require the creation by the trustee of a rather elaborate spreadsheet when dealing with numerous individual assets (think of brokerage accounts with dozens of individual stock positions), but the result would be a well ordered cascade of basis increase.[16]

If the spouse serves as the (or a) trustee, might the IRS argue that he or she has an indirect power to manipulate gains and losses on investments, and therefore basis, which in effect gives the spouse a GPOA over all of the trust's assets up to the remaining applicable exclusion amount? Presumably not. Treasury Regulation Section 25.2514-1(b)(1) provides that "[t]he mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment."

4. Limiting the GPOA to Avoid Diversion of Assets and Loss of Asset Protection. Just how broad of a general power must the surviving spouse have to obtain a new cost basis? From a tax standpoint, the goal of the formula GPOA should be like our wish for children (to be seen but not heard) or perhaps like a grantor's intent with typical *Crummey* withdrawal rights (to be granted but not exercised). After all, it is the *existence* of the GPOA that gives rise to the basis adjustment—not its exercise. The IRS has historically had every incentive to find a GPOA even on the narrowest of pretexts, since in the past, a GPOA typically produced more revenue in the form of estate

[16] For a formula that seeks to exercise a power of appointment in this cascading asset-by-asset fashion (although in the context of springing the "Delaware Tax Trap" discussed below, see Exhibit E.

tax than it lost by virtue of basis adjustments. Courts have gone along, finding a GPOA to exist even where the holder of the power didn't know it existed, or couldn't actually exercise it due to incapacity. *See, e.g., Fish v. U.S.*, 432 F2d 1278 (9th Cir 1970), *Est. of Alperstein v. Comm'r*, 613 F2d 1213 (2nd Cir 1979), *Williams v. U.S.*, 634 F2d 894 (5th Cir. 1981). The breadth of the statutory language and Treasury regulations in finding a GPOA, together with favorable law in the asset protection context, mean that GPOAs can be drafted to pose little threat to the estate plan.

If a LEPA trust (described above at page 19) is used, the general power of appointment must include the spouse or spouse's estate (and not just creditors of the spouse's estate), and must be "exercisable by such spouse alone and in all events." IRC § 2056(b)(5). However, if no marital deduction is to be claimed, as is typically the case with a bypass trust OBIT, some limitations may be included.

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

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

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

Furthermore, as noted earlier, a general power is still a GPOA if it may only be exercised with the consent of a non-adverse party. IRC § 2041(b)(1)(C)(ii). In fact, even a trustee with fiduciary duties to adverse beneficiaries is not considered adverse. *See Est. of Jones v. Comm'r*, 56 TC 35 (1971); *Miller v. U.S.*, 387 F2d 866 (1968); Treas. Reg. § 20.2041-3(c)(2), Ex. 3. For example, one might add to the above language: "However, my [spouse] may exercise [his/her] power of appointment only with the consent of [name of non-adverse party, and/or] the trustee, who must be a non-adverse party." The document would then need to include provisions to enable appointment of a non-adverse party as trustee if, for instance, the spouse was the trustee. If a non-adverse party is named, it would be prudent to name alternates in the event the first is deceased or incapacitated.[17]

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

5. Exposure to Creditors. Does granting a surviving spouse a testamentary power to appoint trust property to the creditors of his or her estate mean that those creditors can reach the trust property even if the property is not so appointed? The answer will depend upon local law. For example, it would not appear so in Texas. The spendthrift provisions of the Texas Trust Code generally permit a settlor to provide in the terms of the trust that the interest of a beneficiary in the income or in the principal or in both may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. TEX. PROP. CODE § 112.035. While these provisions do not apply to trusts of which the settlor of the trust is also a beneficiary, Texas law makes clear that a beneficiary of the trust may not be considered to be a settlor, to have made a voluntary or involuntary transfer of the beneficiary's interest in the trust, or to have the power to make a voluntary or involuntary transfer of the beneficiary's interest in the trust, merely because the beneficiary, in any capacity, holds or exercises a testamentary power of appointment. *Id.* at (f)(2). This rule is in contrast to the exposure of a *presently exercisable* general power, which will be discussed below.[18]

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

Normally, holding or exercising a limited testamentary power of appointment does not cause estate tax inclusion. IRC § 2041(b)(1)(A). However, estate tax inclusion does result if the power is exercised

[17] The use of a non-adverse party in this context should be contrasted with the problems under Code Section 2041(b)(1)(C) discussed at page 20-21 above regarding naming a third party with the right to grant the spouse a general power of appointment. In the present context, the spouse already holds the optimum power; the requirement of consent from a third party is included only to make it harder for the spouse to actually exercise the power in a manner inconsistent with the grantor's wishes.

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

> 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).[19]

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

1. General Principles. While applying the DTT to specific situations can be somewhat complex, the statutory language noted above is relatively straightforward. The statute causes property to be included in the power holder's estate, even if the power holder has only a limited power of appointment, if it is *actually exercised* in a way that restarts the running of the Rule Against Perpetuities without regard to the date that the original power of appointment was created. Since exercising a limited power of appointment (usually thought of as "safe" for estate tax purposes) in a way that restarts the Rule Against Perpetuities might cause inadvertent estate tax inclusion, many states have enacted "savings clauses" into their statutes that restrict the ability of the holder of a limited power to trigger the trap in most instances.[20] In addition, some estate planning attorneys have drafted tightly drawn Rule Against Perpetuities savings clauses in Wills or trust agreements that prevent limited powers of appointment from being exercised in a way to trigger the trap. If the drafting language does not prevent triggering the trap, then despite most state law restriction, there is usually one method left out of state savings statutes that appears to be available in most states.[21]

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

Might an argument be made that in order to trigger estate tax inclusion, the power must be exercised in favor of someone other than the person who would receive the property in default of the exercise? Fortunately, Treasury regulations make it clear that is not the case. Treasury Regulation Section 20.2041-1(d) provides: ". . . a power of appointment is considered as exercised for purposes of section 2041 even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of

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

[20] For a survey of state law provisions, *see* Zaritsky, *The Rule Against Perpetuities: A Survey of State (and D.C.) Law*, specifically pp. 8-10 available at: http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf. *See also* Blattmachr and Pennell, *Using the Delaware Tax Trap to Avoid Generation Skipping Transfer Taxes*, 68 J. OF TAX'N 242 (1988); Blattmachr and Pennell, *Adventures in Generation-Skipping, or How We Learned to Love the Delaware Tax Trap*, 24 REAL PROP. PROB. & TR. J. 75 (1989). While the cited articles do not discuss using the DTT for basis planning, the discussion is nevertheless helpful. *See also,* Spica, A *Practical Look at Springing the Delaware Tax Trap to Avert Generation Skipping Transfer Tax*, 41 RPTL J., 167 (Spring 2006); Greer, *The Delaware Tax Trap and the Rule Against Perpetuities*, EST. PL. J. (Feb. 2001); Culler, *Revising the RAP*, PROB. L. J. OF OHIO (Mar./Apr. 2012).

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

appointment are identical or whether the appointee renounces any right to take under the appointment."

3. Gaining a Step-Up. Issues associated with springing the DTT could themselves be the subject of an entire seminar, but suffice it to say that under common law, for the surviving spouse to exercise the power of appointment in order to cause estate tax inclusion, he or she must effectively grant someone a presently exercisable general power of appointment. Thus, for example, the surviving spouse could appoint low-basis bypass trust property into trusts for his or her children which then grant the children inter vivos general powers of appointment.[22] The exercise of a limited power of appointment in this manner would permit the children to appoint the property in further trust, restarting the applicable Rule Against Perpetuities. As a result, the exercise of the limited power of appointment would generate a step-up in basis at the surviving spouse's death under Section 1014(b)(9) of the Code.

4. Drafting to Enable Use of the DTT. The use of the DTT strategy does not require any particularly complex drafting in the bypass trust. It should be sufficient that the trust grants the surviving spouse a limited testamentary power of appointment, and that any Rule Against Perpetuities savings clause in the Will does not prevent exercising that power in a manner that restarts the Rule. The surviving spouse will need to draft a Will that exercises the power in a very precise manner, either by expressly exercising it over specific assets whose combination of basis increase and value create favorable tax results, or by exercising it in a formula manner to achieve optimal basis adjustment results. The cascading asset-by-asset formula approach described above beginning on page 23 with regard to formula GPOAs could be adapted to cause this result. Sample language providing for a formula exercise of the Delaware Tax Trap is included as Exhibit E.

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

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

PEG powers might force the next generation to obtain a new cost basis at the expense of foregoing asset protection, income shifting, and GST tax exemption. These difficulties could be avoided if states would amend their Rule Against Perpetuities statutes (or their statutes governing powers of appointment) to permit the exercise of limited powers of appointment to restart the Rule Against Perpetuities by creating further *limited* powers, instead of PEG powers, while expressly declaring an intention to thereby trigger the DTT.

[22] Treas. Reg. § 20.2041-3(e)(2).

D. Is the DTT Safer than a Formula GPOA? Some practitioners may prefer using the Delaware Tax Trap for another reason altogether. They may fear that the surviving spouse's control of his or her net taxable estate value (either through spending, or by leaving assets to charity or new spouse), may permit indirect control of the value of the assets in the bypass trust subject to the formula GPOA. If that argument were to prevail, the IRS might seek to include all of the bypass trust assets in the surviving spouse's estate, and not just the "optimum" amount. Proponents of the formula GPOA approach note that formula funding clauses based on a surviving spouse's available GST tax exemption amount have been used for decades in GST tax non-exempt trusts without giving rise to this argument by the IRS.[23] However, there is some plausibility to the argument.

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

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

The Tax Court's rationale was that the condition precedent cited by the estate was illusory and lacked any independent non-tax consequence or significance. The appellate court preferred a test that looked through the formalities to determine how much wealth the decedent actually controlled at the time of her death. It looked to examples in the relevant Treasury regulations and noted that the examples of contingencies which precluded inclusion were not easily or quickly controlled by the power holder.

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

> More importantly, unlike *Kurz*, it is not subject to a condition precedent, nor does the capping of the GPOA hinge **at all** on Treas. Reg. § 20.2041-3(b) [regarding conditional powers of appointment]—it is pursuant to other treasury regulations cited herein [specifically, Treas. Reg. § 20.2041-1(b)(3): Powers over a portion of property]. Additionally, unlike the ability of a beneficiary to withdraw at will as in *Kurz*, which the appellate court deemed "barely comes within the common understanding of 'event or . . . contingency'", the ability of an OBIT formula GPOA powerholder (if it would otherwise be capped) to increase their testamentary GPOA would require giving away or spending a significant portion of their assets (quite unlike *Kurz)*—a significant "non-tax consequence" if there ever was one.[24]

Until greater certainty is provided on the issues, whether by the IRS or the courts, some practitioners may prefer avoiding even the hint of a *Kurz*-type argument against formula GPOA caps. The more conservative approach would be to require the GPOA formula to be applied, ignoring any charitable or marital deduction otherwise available to the surviving spouse's estate.[25] In most cases and estate plans, spouses are unlikely to be making large charitable or marital gifts, so ignoring these adjustments is unlikely to make much if any difference.

Unlike a formula GPOA, the Delaware Tax Trap is only applicable to the extent that the surviving spouse affirmatively exercises his or her limited power of appointment ("LPOA") to trigger the trap. There is no danger of the mere existence of an LPOA (or a lapse of an LPOA) causing inclusion under Code Section 2041(a)(3) just because the surviving spouse has the

[23] *See* Morrow, fn. 12, at p. 21.

[24] Morrow, fn. 12, at p. 37.

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

authority to exercise it. Therefore, using the Delaware Tax Trap technique is immune from *Kurz*-type arguments. As a result, many attorneys may prefer it.

V. WHAT WORKS NOW?

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

A. Intra-Family Loans. One of the most attractive wealth-transfer strategies is also one of the simplest–a family loan.[26] 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 September, 2014, when Bankrate.com quoted the rate on a 30-year mortgage at around 4.16%, the Applicable Federal Rate ranged from 0.36% to 2.97%, depending on the loan's term.

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

Example 25: In September, 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 1.86% over the next nine years instead of the 4.20% offered by their bank, the couple will save over $9,300 in interest costs the first year alone, while reducing their monthly payments by $505 from $1,956 to $1,451. 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. However, this section of the Code generally deals with interest-free or "below-market" loans between related taxpayers—not the type of loan described above. For family loans, Section 7872 provides that a below-market loan will be treated as a gift loan, resulting in the imputation of a gift from the lender to the borrower in an amount equal to the 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 describes how to avoid one. It requires the IRS to set the "market" rate for loans each month. As long as the family charges the rate set out by the IRS, the "imputed interest" rules of Section 7872 are avoided. With IRS interest rates at historically low levels, there is no need for families to make "below-market" loans and incur the harsh results. A loan at the market rate set by the IRS works just fine.

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 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

[26] For a thorough discussion of this subject, *see* Akers and Hayes, *Estate Planning with Intra-Family Loans and Notes*, 47 UNIV. OF MIAMI HECKERLING. INST. ON EST. PL. ch. 5 (2013).

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 return in excess of the IRS interest rate that the junior family member earns by investing the principal of the loan that escapes estate taxation. Of course, as discussed above, the senior family members may use their gift tax annual 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. (IDGTs are discussed in more detail beginning at page 32 below.)

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

b) Other Aspects. It may be advisable for the grantor trust to be structured as a so-called "perpetual" or "dynasty" trust for the senior family member's descendants, giving the trustee broad discretion to make distributions, rather than mandating any distributions. These trusts have substantial non-tax benefits. For example, if the descendants have problems with creditors, the creditors can attach assets that are distributed to them outright. In contrast, trust assets are generally exempt from attachment as long as the trust has "spendthrift" language. Similarly, a spouse of a descendant may become a creditor in a divorce situation. In community property jurisdictions, outright distributions that are commingled with a spouse could be classified as community property, subject to division by a divorce court. Keep in mind that even a spendthrift trust may not be exempt from all

obligations of a beneficiary. *See, e.g.,* TEX. FAM. CODE § 154.005 (court may order trustee of spendthrift trust to make disbursements for child support obligation of beneficiary if trustee is required to make distributions to beneficiary; if distributions are discretionary, court may order child support payments from income but not principal). Properly maintained trust assets cannot be commingled. Also, outright distributions may allow assets to be given away to individuals outside of the senior family member's bloodline. With a trust, the senior generation can choose to put limits on the people that will benefit from the gift. In addition, upon the death of a beneficiary, if an outright distribution is made, the beneficiary's share would be included in his or her gross estate for federal estate tax purposes. If, however, the grantor trust is exempt from the generation-skipping transfer tax ("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 September, 2014 rates on August 20th. 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 September, 2014) are as follows:

(1) Short-term annual interest rate – 0.36%

(2) Mid-term annual interest rate – 1.86%

(3) Long-term annual interest rate – 2.97%

Rev. Rul. 2014-22, 2014-37 IRB 533.

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 better to draft the note to provide for the payment of interest only during its term, with principal due only at maturity. While the unpaid principal balance will be included in the lender's estate if he or she dies before the loan is repaid, a note providing for interest-only payments lets junior family members use funds as long as possible (and may provide more of an opportunity for senior family members to reduce the principal balance through annual exclusion gifts, if they choose to do so). Keep in mind that this structure is more aggressive than the typical loan format.

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. 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. Even taxable gifts may make sense, since the gift tax is tax exclusive (i.e., it is based upon the net amount received by the donee), whereas the estate tax is tax inclusive (i.e., all dollars are subject to the estate tax, including the dollars used to pay the tax). It is

important to remember that for estate tax reporting, adjusted taxable gifts are added back in as part of calculating the gross estate tax. IRC § 2001(b).

Example 26: 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 17,000, the current value of assets transferred out of Gary and Gwen's estate is nearly $1 million.

Example 27: Dave has a large estate well in excess of any funds he will spend during his lifetime. He has used all of his gift tax exemption, and plans to transfer $12 million to his children either now or when he passes away. If he waits until his death, the tax on $12 million will be $4,800,000, (40% of $12 million) leaving $7,200,000 for his children. If Dave makes the gift today, he could give the kids $8,571,429, in which case the gift tax (ignoring annual exclusions) would be $3,428,571 (40% of $8,571,429), fully exhausting Dave's $12 million. Assuming that Dave lives for at least three years after the gift, the net result is an additional $1,371,429 to the children. While Dave will have to pay the gift tax next April 15th instead of waiting to pay the estate tax at death, the kids will have the $8.57 million, *plus growth* during Dave's lifetime, without any additional gift or estate tax.

Specifics.

1. What to Give. Despite the basis issues discussed below (and above), estate planners generally recommend making outright gifts when market conditions are depressed–sometimes called "natural discounting" (i.e., making gifts of stock when the stock market takes a significant downturn, or gifts of real estate when the real estate market is depressed). As mentioned above, post-gift appreciation lands in the junior generation's hands with no gift or estate tax. In the first example above, if Gary and Gwen consistently make 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. Carryover Basis. In making gifts, the issue of basis is always important. While an inherited asset generally gets a new cost basis equal to its value for federal estate tax purposes, property received by gift generally receives a carryover of the donor's basis, increased (but not above fair market value) by the amount of any gift tax paid with respect to the gift. IRC § 1015. In fact, if the beneficiary sells the property for less than the donor's basis, the beneficiary may have his or her basis limited to the fair market value of the property at the date of the gift, if that value is less than the donor's basis. IRC § 1015(a). However, with top capital gains rates at 23.8% and the top estate tax rate at 40%, in most situations, a gift is still more beneficial from an overall tax perspective. This is especially true if the gifted asset is held for a long period of time (thereby deferring the recognition of any income tax payable on the gain), and continues to appreciate in value after the gift is made. One can determine how much an asset must appreciate for any estate tax savings to exceed the income tax costs of a loss of basis step-up by applying an algebraic formula to compute a "tax efficient appreciation factor." The formula of 1 + [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 1.29 (to $6.7 million) for the estate tax savings to offset the income tax cost associated with a loss of step-up in basis: 1 + [$1 million x ((.238/(.40-.238))/$5 million] =

1.29. *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 below, the impact of income taxes on the junior family members needs to be considered. If the senior family members want to assume responsibility for tax on the income earned on the gifted property, the gift can be made to a grantor trust instead of outright to the junior family members. That way, the income tax burden on the assets gifted to the junior family members can remain the responsibility of the senior family member without any additional gift tax. *See* Rev. Rul. 2004-64, 2004-27 IRB 7.

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

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

The Technique. 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 or limited liability companies are also popular. Most commentators agree that to be a credit-worthy borrower, the IDGT must have some assets in excess of the borrowed funds with which to repay the note. Also as mentioned in the prior discussion regarding grantor trusts, "seed money" in the 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 28: 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 September, 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 tax exemption to shelter the trust from the GST tax. With $1 million in cash, plus a $9 million loan from Clint, the trust will buy Clint's limited partnership interest valued at $10 million. The 20-year note from the IDGT to Clint bears interest at the Applicable Federal Rate, which for loans of more than 9 years, was 2.97% in September, 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 2.97% 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 $46 million, even after paying out $267,300 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 $37 million, which will be available to Clint's children and grandchildren without having paid any gift or estate tax.

Because IDGTs are grantor trusts, Clint won't owe any income tax on the gain he realizes by selling his limited partnership interest to the trust, nor will he have to pay income tax on the interest payments he receives. *See* Rev. Rul. 85-13, 1985-1 CB 184. As far as the IRS is concerned, it's as if Clint sold the asset to himself.

Clint will, however, owe income tax on the partnership's earnings. In this example, though, the interest paid to Clint will more than offset his tax liability so long as the effective tax rate (earned through a combination of dividends, capital gains, and other income) is less than 33.5% or so. There are plenty of caveats. Neither the Code nor case law specifically addresses IDGTs, and the IRS has been known to challenge them. 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 Est. of Donald Woelbing v. Comm'r* (Docket No. 30261-1); *Est. 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.[27] 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), 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.[28] 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). Keep in mind that no "correct" way to determine the amount of this fee has been established.

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

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

[28] Both the Tax Court and the 9th Circuit recognized this belief in footnotes in *Est. of Petter v. Comm'r*, TC Memo 2009-280, aff'd 653 F3d 1012 (9th Cir. 2011).

partnership (or similar entity) prior to being sold to the IDGT, distributions of partnership rental or investment income to the IDGT can be used to service the note payments. 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 (IRS alleged that regular distributions made from a limited partnership in order to service debt incurred in order to purchase interests was a transfer with a retained right to income, causing partnership to be included in transferor's estate under IRC § 2036).

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

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), Ex. 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. (Aug. 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 Tax 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 tax inclusion ratio of zero, which means that all of the assets in the IDGT (both the seed money and the growth) can pass on to grandchildren or more remote generations with no additional estate or gift tax, and without any GST tax. This multi-generational feature can make a sale to an IDGT a much more powerful transfer tax tool than other similar wealth-shifting techniques.

9. Selling Discounted Assets. 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.

D. Grantor Retained Annuity Trusts. With a grantor retained annuity trust, or "GRAT," heirs typically won't receive quite as much as they would with an IDGT. But GRATs are also less risky, in part because they can be set up to completely avoid any gift tax consequences. Moreover, because the Code sanctions them, as long as the guidelines are followed, there is very little risk of running afoul of the IRS. In fact, GRATs have been so successful that Obama's most recent budget proposal, following similar requests in 2010-2013, 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.[29]

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

The Technique. In many ways, GRATs resemble loans. The grantor sets up a trust and transfers property to the trust. The trust itself requires the trustee to make payments to the grantor in the form of an annuity. As with a loan, a GRAT matures within a specified number of years. As a result, any money (or assets) that the client puts into the GRAT will be returned through the annuity payments by the time the trust 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 29: 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 September, 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, value the stock, and report the gift), but the GRAT will simply pay her back what's left of her investment by the time it expires–no one is required to make up for a shortfall.

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

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

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

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

3. Gift on Formation. Upon the creation of the GRAT, the grantor is treated as making a gift to the ultimate beneficiaries equal to the initial value of the trust assets, reduced by the present value of the annuity payments retained by the senior family member. 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. The IRS can't come back at the end of the GRAT term and re-assess how the GRAT actually did to measure the gift tax. The trustee of the GRAT must be sure to make the annuity payments to the grantor on time, pursuant to the terms of the GRAT. Otherwise, the IRS could recharacterize the gift as a gift of the full value of the gifted asset on formation, with no reduction for the value of the promised annuity payments.

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). Regardless of whether the annuity payment is made in cash or in kind, the payment must be made within 105 days of the anniversary date of the GRAT if payment is based on the date of the trust, or by the due date of the trust's income tax return (without regard to extensions) if the payment is based on the trust's tax year. Treas. Reg. § 25.2702-3(b)(4).

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 Tax 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 vs. Long-term GRATs. As indicated above, the use of short-term (i.e., 2-year) GRATs have typically been more popular than using longer-term GRATs. The reasoning behind the preference for short-term GRATs is twofold. First, using a short-term GRAT reduces exposure to the risk that the senior family member will die during the term, which, as stated above, would cause all or a portion of the value of the GRAT assets to be included in the senior family member's gross estate. Second, a short-term GRAT minimizes the possibility that a year or two of poor performance of the GRAT assets will adversely impact the overall effectiveness of the GRAT. When funding a GRAT with volatile securities, a series of short-term GRATs typically perform better than a single long-term GRAT. Notwithstanding the benefits of short-term GRATs illustrated above, in times of low interest rates, a longer-term GRAT may be more desirable because it allows the senior family member to lock in a low 7520 rate for the duration of the GRAT term. *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.

E. 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 30: 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 September, 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 if he has not used up his exemption, he will not have to pay gift tax on the gift to his kids. If the trust invests its assets at an average return of 8% per year, the trust will have nearly $2.4 million in it at the end of the 20th year, even after paying $50,000 per year to Charlie's favorite charity. This property will pass to Charlie's kids at a cost of only $197,990 of Charlie's gift tax exemption. One caveat that clients have to remember: As with most gifting strategies, once you put money into one of these trusts, you can't get it back. The trust has to be irrevocable to work.

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

Specifics.

1. Structure. In the usual case, senior family member transfers assets to the CLAT. The trust pays a fixed dollar amount to one or more charities for a specified number of years. Alternatively, the CLAT may be structured to last for the life or lives of (a) the senior family member; (b) his or her spouse; and/or (c) a lineal ancestor (or spouse of a lineal ancestor) of all of the remainder beneficiaries (or a trust in which there is less than a 15% probability that individuals who are not lineal descendants will receive any trust corpus). Treas. Reg. § 1.170A-6(c)(2)(i)(A). Unlike a GRAT (or a charitable remainder trust), a CLAT is not subject to any minimum or maximum payout. The CLAT may provide for an annuity amount that is a fixed dollar amount, but which increases during the annuity period, 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* PLRs 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, and the CLAT receives an income tax deduction for the amount paid to charity each year. IRC § 642(c)(1).

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

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

7. GST Tax Issues. Unlike with a GRAT, the grantor is technically permitted to allocate a portion of his or her 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 actual rate of growth of the trust assets. IRC § 2642(e)(2). Therefore, there is at least some adjustment to the exemption allowed. 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.

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 have traditionally been used to value the SCIN premium, so long as the seller isn't "terminally ill." For caution in using this presumed valuation method, see CCA 20133033 and the IRS petitions in the *Davidson* cases, cited below. 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 31: 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 September, 2014, the required interest rate on a SCIN for a 70-year-old, including the mortality risk premium, would have been 5.76%, corresponding to an annual interest payment of only $403,200. Over the first 7 years of the SCIN, the trust would have paid Scott a total of $2,822,400 in interest payments. The remaining $17,177,160 of value of the FLP units (nearly $4 million more than that in the prior example) would have been retained by the trust.

Specifics.

1. SCIN Terms. A SCIN is similar to a sale of assets for a traditional promissory note. The note could be structured with regular amortizing payments, or with payments of interest only with a balloon payment due upon maturity. 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 F3d 595 (6th Cir. 2003). Note that while most commentators *presume* that the premiums for SCINs should be based upon IRS actuarial tables, there is no express authority for this proposition. The IRS has recently taken the litigation position that those tables may not apply when valuing a SCIN, even if the taxpayer's actual life expectancy is within the safe harbor for use of those tables, discussed below. The IRS has argued that (i) the notes may not be valid notes if the buyer may lack the wherewithal to pay the note plus a substantial SCIN premium; and (ii) the Section 7520 valuation tables do not by their terms apply to promissory notes, and instead a willing-buyer willing-seller standard must be used to value the notes, based upon the seller's actual medical history on the date of the gift.[30] *See* CCA 201330033; *Davidson v. Comm'r*, TC 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,

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

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 US 278, 285 (1960). It is well settled that cancellation of a debt can be the means of effecting a gift. *See, e.g., Helvering v. American Dental*, 318 US 322 (1943). A testamentary cancellation of a debt owing to the decedent can similarly be the means of effecting a gift in the form of a bequest. TAM 9240003.

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* 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." No mortality premium is required. As is the case with the SCIN, the buyer can be a junior family member, or an IDGT. Because of 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 32: 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 September, 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. Structure. A private annuity works much like a SCIN. The senior family member transfers assets to a junior family member in exchange for junior's promise to make fixed payments to senior for the remainder of senior's life. Because the annuity terminates upon the senior family member's death, it is not 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. Taxpayers have assumed that IRS mortality tables made be used for a SCIN. With a private annuity, Treasury regulations expressly provide that the standard mortality tables of Section 7520 of the Code may be used, provided that the taxpayer is not "terminally ill." Treas. Reg. § 25.7520-3(b)(3). As explained above, 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 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 requiring 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) requires that the annuity payments be made without regard to whether the property transferred produces income (perhaps including a personal guarantee by trust beneficiaries where the transferee is a trust); (ii) provides for an annuity payment that is substantially different from the amount of income produced by the transferred property; and (iii) arranges for the transferee to have assets in addition to those transferred in exchange for the annuity promise to ensure "coverage" for the annuity payments. Again, a large federal gift tax exemption makes fulfilling these requirements more palatable for many clients.

5. Outliving the Tables. Unlike a SCIN, the payments under a private annuity need not end at a fixed maturity date (so long as the exhaustion test is met), but may be extended for the client's lifetime. This continuation of payments may be a comfort to clients who are concerned about giving away "too much," and not retaining enough to support themselves for the rest of their lives. But like a SCIN, a private annuity poses an estate tax risk that the payments made

will actually add value to the senior family member's estate if he or she lives to maturity. In fact, if the private annuity is structured to require payments for the lifetime of the transferor, and if the senior family member lives well beyond his or her life expectancy, these additional payments can add substantial value (and taxable income) to the recipient's estate.

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 2014).

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 family, including a parent or 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 from junior an asset with lots of appreciation potential. Initially, the trust would be set up much like an IDGT, 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 a 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 33: 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 tax exemption to shelter the trust assets from estate tax when Jenny dies. Despite the fact that Jenny has the lifetime use of the trust property: (i) it can't be attached by her creditors; (ii) it can pass to Jenny's children, or whomever Jenny wishes to leave it to, without estate tax; (iii) principal from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants without gift tax; and (iv) if the trust isn't a grantor trust as to Jenny, income from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants, thereby providing the ability to shift the trust's income to taxpayers in low income tax brackets.

Specifics.

1. Structure of the APGT. Although the term "accidentally perfect" distinguishes this trust from an "intentionally defective" trust, there is nothing accidental about it. The key to the success of an APGT is the creation by a junior family member of an irrevocable trust that (i) successfully avoids estate tax inclusion for the junior family member under Sections 2036 through 2038 of the Code; but (ii) which will intentionally cause estate tax inclusion for a senior family member who has estate tax (and 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 regardless.

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 is in the APGT. The goal of an APGT is the same regardless: The assets ultimately pass 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 Treasury 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. In some states, since the trust was originally created by junior, a court might be empowered to award trust assets to junior's creditors if junior becomes a beneficiary of the trust. In that event, the IRS might assert that Section 2041(a)(2) of the Code (transfer with a retained right to appoint property to one's creditors) applies to subject the resulting trust to estate tax in junior's estate. States with domestic asset protection trust statutes may avoid this concern. In addition, other states may include features in their spendthrift statutes or otherwise to provide protection in this circumstance. *See, e.g.,* TEX. PROP. CODE § 112.035(g)(3)(B) (beneficiary's possession of general power of appointment precludes trust contributions from being treated as being made by grantor for purposes of applying Texas spendthrift protection).

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

8. Selling Discounted Assets. As with 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) are transferred to younger family members, while "senior interests" (the preferred stock) are 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 34:. Fred places $10,000,000 worth of stocks, bonds, real estate, and other holdings into a limited partnership which (in addition to a 1% general partnership interest retained by Fred), provides for two classes of limited partnership interests. The preferred interest is entitled to receive the first $350,000 of partnership distributions made in any year. Any partnership distributions in excess of $350,000 per year are paid to the common partnership interest owners. If partnership distributions are less than $350,000 in any year, the unpaid amount is carried forward as a

preference owed to the holders of the preferred interest in future years. In addition, when the partnership liquidates, the preferred owners are entitled to receive the first $5,000,000 worth of liquidation proceeds, with any excess passing to the holders of the common interests. If the assets in the partnership grow at 10% per year for fifteen years, the holders of the preferred interest would receive $350,000 per year, plus $5,000,000 upon the liquidation of the partnership, while the holders of the common interest would be entitled to receive the balance of the partnership assets, over $25,652,000. The preferred interests are effectively "frozen" in value at $5,000,000 while the common interests enjoy the balance of the growth.

Specifics.

1. Structure. Section 2701 of the Code provides that when a person transfers an interest in a corporation or limited partnership to a "member of the transferor's family" (generally, the transferor's spouse, descendants of the transferor or transferor's spouse, or the spouses of those descendants), certain rights retained by the transferor must be valued at zero. 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 Treasury regulations generally require any gift of an interest in the corporation or partnership to be valued at the value of all interests held before the gift, less the value of the interests retained by the transferor. 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 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 September, 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 minus 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.

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. Historically large (inflation adjusted) estate tax exemptions, together with "permanent" portability, higher income tax rates and new income taxes, all combine to change 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

Historical Estate, Gift and GST Tax Exemption Amounts and Top Tax Rates (1942-2015)

Year	Applicable Exemption or Exclusion Amount	Gift Tax Exemption	GST Tax Exemption	Top Marginal Rate
1942-1976	$60,000	$60,000	No GST Tax	77%
1977	$120,000	$600,000	1st GST Tax (repealed)	70%
1978	$134,000	$600,000	1st GST Tax (repealed)	70%
1979	$147,000	$600,000	1st GST Tax (repealed)	70%
1980	$161,000	$600,000	1st GST Tax (repealed)	70%
1981	$175,000	$600,000	1st GST Tax (repealed)	70%
1982	$225,000	$600,000	1st GST Tax (repealed)	65%
1983	$275,000	$600,000	1st GST Tax (repealed)	60%
1984	$325,000	$600,000	1st GST Tax (repealed)	55%
1985	$400,000	$600,000	1st GST Tax (repealed)	55%
1986	$500,000	$600,000	1st GST Tax (repealed)	55%
1987-1997	$600,000	$600,000	$1,000,000	55%
1998	$625,000	$625,000	$1,000,000	55%
1999	$650,000	$650,000	$1,000,000	55%
2000	$675,000	$675,000	$1,000,000	55%
2001	$675,000	$675,000	$1,000,000	55%
2002	$1,000,000	$1,000,000	$1,000,000	50%
2003	$1,000,000	$1,000,000	$1,000,000	49%
2004	$1,500,000	$1,000,000	$1,500,000	48%
2005	$1,500,000	$1,000,000	$1,500,000	47%
2006	$2,000,000	$1,000,000	$2,000,000	46%
2007	$2,000,000	$1,000,000	$2,000,000	45%
2008	$2,000,000	$1,000,000	$2,000,000	45%
2009	$3,500,000	$1,000,000	$3,500,000	45%
2010	$5,000,000 or unlimited[31]	$1,000,000	No GST Tax (rate=0%)	35% or 0%
2011	$5,000,000	$5,000,000	$5,000,000	35%
2012	$5,120,000	$5,120,000	$5,120,000	35%
2013	$5,250,000	$5,250,000	$5,250,000	40%
2014	$5,340,000	$5,340,000	$5,340,000	40%
2015	$5,430,000 (projected), as adjusted for inflation	$5,430,000 (projected)	$5,430,000 (projected)	40%

[31] 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.

EXHIBIT B

Sample Pre- Post- Nupt Clauses Regarding Portability[32]

From David Gollin, Minneapolis, MN:

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

From Michael Whitty – Chicago Illinois:

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

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

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

[32] Used with permission of the respective authors.

EXHIBIT C

Sample Letters Regarding Portability

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Re: Estate of ________________, Deceased

Dear __________________:

As we have discussed, it does not appear that the preparation and filing of a Federal Estate Tax Return (Form 706) will be required since the value of [your spouse]'s estate 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 the total value of [your spouse]'s estate is $1,000,000 and all of the estate passes to the [Family/Bypass] Trust created in [his/her] Will [change statement and numbers if passes outright to spouse or otherwise], $1,000,000 of [his/her] exemption will have been used, leaving [$4,340,000] of unused exemption. If you file the Form 706 in a timely manner, you and your estate will have the ability to use [his/her] [$4,340,000] of unused exemption, plus the amount of your own exemption, for gift and estate tax purposes. Depending on the amount of [your spouse]'s unused exemption, this could substantially increase the gift tax exemption available to you during your lifetime and the estate tax exemption available to you at your death. Continuing the example above, if the exemption is [$5,340,000] upon your death, your estate would have [$9,680,000] of available exemption ([$4,340,000] of [your spouse]'s unused exemption plus your [$5,340,000] exemption).

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

[INCLUDE THE PARAGRAPH BELOW IF SS HAS NOT DECIDED ABOUT PORTABILTY RETURN]

As a result of current law, it is prudent to plan with the assumption that if the value of your estate, including life insurance death benefits, exceeds [$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 no later than ________________.

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

If you anticipate that your estate may be in excess of the exemption amount (under current law, this exempt amount is [$5,340,000 for 2014] and is subject to an inflation adjustment each year), it would be prudent to consider filing a Form 706 for [your spouse]'s estate to take advantage of portability. If your estate exceeds this exemption when you die, your estate would owe estate tax (at current rates) equal to 40% of the amount above the exemption. Filing a Form 706 could substantially increase the threshold above which estate taxes would be due.

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

____
____
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Re: Estate of ________________, Deceased

Dear _________________:

By letter dated ___________________, we wrote to you regarding the option of preparing and filing a federal estate tax return (Form 706) to be eligible to benefit from the law that became effective January 1, 2011, which provides for "portability" of your [spouse]'s federal estate tax exemption to you. I am including a copy of that letter for your reference.

If you would like for us to assist you with the preparation and filing of the Form 706, please contact me **no later than** ______________. If we do not hear from you by that date, we will assume that you have decided not to file a Form 706 for portability purposes, and we will **not** take any steps to prepare the Form 706.

EXHIBIT D

Sample *Clayton* QTIP Trust Language

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

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

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

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

3. Each of Portion A and Portion B is intended to be a fractional share which participates in appreciation and depreciation occurring in the property disposed of under this Article. Subject to the provisions of paragraph ___ of Article ______, each portion may be funded with cash or other property, or a combination thereof, and any such other property so used shall be valued as of the date of distribution.

EXHIBIT E

Sample Exercise of Formula Power of Appointment Triggering the Delaware Tax Trap[33]

2.3. Exercise of Powers of Appointment.

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

B. Exercise of Power. I hereby appoint the property described in Subsection 2.3.C. below to my children who survive me, in equal shares. However, if any child fails to survive me but leaves one or more descendants who survive me, I give the share that child would have received (if he or she had survived) per stirpes to his or her descendants who survive me. All of the preceding distributions are subject to the provisions of Article ___ (providing for lifetime Descendant's Trusts [*that grants the primary beneficiary thereof a presently exercisable general power of appointment*] for my children and other descendants).

C. Extent of Exercise. The foregoing exercise does not apply to the following assets held by the Trust: (i) cash or cash equivalent accounts (such as savings accounts, certificates of deposit, money market accounts or cash on hand in any brokerage or equivalent accounts); (ii) property that constitutes income in respect of a decedent as described in Code Section 1014(c); (iii) any interest in any Roth IRA accounts or Roth variants of other retirement plans, such as Roth 401(k)s, 403(b)s, 457(b)s, and the like; and (iv) any interest in any property that has a cost basis for federal income tax purposes that is greater than or equal to the fair market value of the property at the time of my death (the "Excluded Assets"). If, after eliminating the Excluded Assets, the inclusion of the value of the other assets in the Trust in my taxable estate for federal estate tax purposes would not increase the federal estate tax and state death taxes payable from all sources by reason of my death, this power of appointment shall apply to all remaining assets of the Trust other than the Excluded Assets (the "Included Assets"). However, in the event that the inclusion of the value of all of the Included Assets in the Trust in my taxable estate for federal estate tax purposes would increase the taxes so payable, the assets of the Trust appointed by this Section 2.3 shall be further limited as follows: The Trustee shall for each of the Included Assets evaluate the ratio of the fair market value at the time of my death to the cost basis immediately prior to my death first (the "Gain Ratio"). The Trustee shall thereafter rank the Included Assets in order of their respective Gain Ratio. The appointment shall apply first to the Included Asset with the largest Gain Ratio, and thereafter in declining order of Gain Ratio to each of the subsequent Included Assets; however, as such point that inclusion of the next in order of the Included Assets would otherwise cause an increase in my estate's federal or state estate tax liability as described above, my appointment pursuant to this Section 2.3 shall be limited to that fraction or percentage of that Included Asset that will not cause any federal or state estate tax liability, and all lower ranked Included Assets shall be excluded from the exercise of this power of appointment.

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

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