The Optimal Basis Increase and Income Tax Efficiency Trust

Exploiting Opportunities to Maximize Basis, Lessen Income Taxes and Improve Asset Protection for Married Couples after ATRA (or: why you'll learn to love the Delaware Tax Trap)
(this version updated August 2014)[1]

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[1] Portions of this outline were presented at other CLEs 2011-2013 and were published in Trusts and Estates (Dec. 2012) and Leimberg LISI Estate Planning Newsletter or CCH Estate Planning Review. – Contact: *edwin_p_morrow@keybank.com*, *or edwin.morrow3@gmail.com*. See this website for further updates: http://ssrn.com/abstract=2436964 or http://dx.doi.org/10.2139/ssrn.2436964

Part I – New Problems with Traditional AB Trust Design and Adapting to Portability

"It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change." – Charles Darwin

For many taxpayers, the traditional trust design for married couples is now obsolete. This article will explore better planning methods to maximize basis increase for married couples (and, for future generations), exploit the newly permanent "portability" provisions, maximize adaptability to future tax law, enable better long-term income tax savings and improve asset protection over standard "I love you Wills" *and* over standard AB trust planning. Primarily, this article focuses on planning for married couples whose estates are under $10.5 million, but many of the concepts apply to those with larger estates as well.

First, we'll describe the main *income* tax problems with the current design of most trusts in light of portability and the new tax environment – and problems with more simplified "outright" estate plans (sophisticated practitioners should skip this section). In Part II, we'll describe potential solutions to the basis issue, including the use of various marital trusts (and the key differences between them), and why these may also be inadequate. In Part III, we'll explore how general and limited powers of appointment and the Delaware Tax Trap can achieve better tax basis adjustments than either outright bequests or typical marital or bypass trust planning. I will refer to any trust using these techniques as an Optimal Basis Increase Trust ("OBIT"). In Part IV, we will discuss how these techniques accommodate disclaimer based planning (or disclaimers from lack of planning). Parts V and VI divert to the "double step up at first death" techniques and ancillary asset protection considerations. Part VII discusses the tremendous value of applying OBIT techniques to *pre-existing* irrevocable trusts. Lastly, in Part VIII, we'll discuss various methods to ensure better *ongoing* income tax treatment of irrevocable trusts – not just neutralizing the negatives of trust income taxation, but exploiting loopholes and efficiencies *unavailable to individuals*. I will refer to these two groups of techniques taken together as an Optimal Basis Increase and Income Tax Efficiency Trust, features of which are summarized in the attached chart in the appendix.[2]

[2] No trademark claimed, "Super-Duper Charged Credit Shelter Trust" was apparently unavailable…

Responding to the Portability Threat -- and Opportunity

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“2010 Tax Act”) introduced a profound change to estate planning that was recently confirmed by the American Taxpayer Relief Act of 2012 (“ATRA”). Section 303 of the 2010 Tax Act, entitled “Applicable Exclusion Amount Increased by Unused Exclusion Amount of Deceased Spouse”, is commonly known as “portability”.[3] ATRA recently made this provision permanent, along with a $5,000,000 exemption for estate, gift and generation skipping transfer tax, adjusted for inflation (even with low inflation, it has already increased to $5,250,000).[4]

The concept of portability is simple: the surviving spouse gets any unused estate tax exclusion of the deceased spouse provided the Form 706 is properly filed. While it does have various flaws and quirks, portability goes quite far to correct a basic injustice that would otherwise occur when the beneficiaries of a couple with no bypass trust planning pay hundreds of thousands (if not millions) more in estate tax than the beneficiaries of a couple with the same assets who die without any trust planning.

Portability has been described as both the “death knell” of the AB Trust[5] as well as a “fraud upon the public”.[6] Ubiquitous popular financial press articles now refer to the “dangers” of traditional AB trust planning or the “death of the bypass trust”. While these charges have some surface justification, they all fail to see the tremendous ***income*** tax and asset protection opportunities opened up to such trusts by the new law – *if* trusts are properly adapted.

The lure of portability and a large exemption is indeed a siren song for some married taxpayers to avoid trusts. Like Odysseus, we should listen to it despite of our misgivings. The new exemption level, coupled with the advantages of portability, eliminates what was previously the most easily quantifiable reasons to do trust planning – saving estate tax - for

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[3] Section 303 of Public Law 111-312, known as the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

[4] Rev. Proc. 2013-15 – it will increase to $5.34 million in 2014

[5] E.g. “AB Trust can be hazardous to your health”, “Serious tax consequences to AB Trust owners” “Portability Threatens Estate Planning Bar”, “Is it time to bypass the bypass trust for good?”, and dozens more

[6] Frequent *Trusts and Estates* author Clary Redd at May 2011 Advanced Trust Planning CLE, Dayton, Ohio - to be fair, he made this comment before the provision was made permanent.

the vast majority of taxpayers. More than that, however, the new tax environment seemingly deters taxpayers from using trusts through significant *income* tax disparities, despite the many non-tax reasons for using them.

What's wrong with the traditional AB trust?

1) **No Second "Step Up" in Basis for the Bypass Trust Assets for the Next Generation.** Imagine John leaves his wife Jane $3 million in a bypass trust and Jane outlives him 10 years. Over that time the income is spent but the fair market value has doubled to $6 million. Jane has her own $3 million in assets. At Jane's death, their children inherit assets in the bypass trust with only $3.5 million in basis. Had John left his assets to her outright or to a differently designed trust and Jane elected to use her Deceased Spousal Unused Exclusion Amount (DSUEA), heirs would receive a new step up in basis to $6 million, potentially saving them $750,000 or more![7]

2) **Higher Ongoing Income Tax**. Any income trapped in a typical bypass or marital trust over $11,950 is probably taxed at rates higher than the beneficiary's, unless the beneficiary makes over $400,000 ($450,000 married filing jointly) taxable income. Including the new Medicare surtax, this might be 43.4% for short-term capital gains and ordinary income and 23.8% for long-term capital gains and qualified dividends. This is a staggering differential for even an upper-middle class beneficiary who might be subject to only 28% and 15% rates respectively.

[7] Of the $3 million original basis, this assumes $500,000 is added due to income or gain realized over time (increasing basis), over the loss in basis due to depreciation or realized losses (which decrease basis), creating $2.5 million unrealized gain times a hypothetical 30% combined federal (23.8%) and state (net 6.2%) long term capital gains tax – this may be higher if you consider 28% rate for collectibles, or if the assets were depreciable property, one might look at the depreciation lost and the ordinary income that could have been offset by the extra basis, which might drive this estimated loss to beneficiaries even higher (though you would have to back out for present value). Of course, if heirs *never* sell the property (and depreciation does not apply) and hold until death, losses resulting from decreased basis would be non-existent. In short, it's a rough "guesstimate". As discussed later herein, some assets do not receive a new basis even if in the decedent's estate, some assets receive a basis not based on the fair market value at date of death. IRC §§691(c), 1014, 2032, 2032A, and some receive de facto step up (Roth IRA, insurance)

3) **Special assets can cause greater tax burden in trust.** Assets such as IRAs, qualified plans, deferred compensation, annuities, principal residences, depreciable business property, qualifying small business stock and S corporations are more problematic and may get better income tax treatment left outright to a surviving spouse or to a specially designed trust. Retirement plan assets left outright to a spouse are eligible for longer income tax deferral than assets left in a bypass trust, even if trust makes it through the gauntlet of "see-through trust" rules and the minefield of planning and funding trusts with "IRD" (income in respect of a decedent) assets.[8] Other assets, such as a personal residence, have special capital gains tax exclusions or loss provisions if owned outright or in a grantor trust.[9] Ownership of certain businesses requires special provisions in the trust that are sometimes overlooked in the drafting, post-mortem administration and/or election stages.[10]

Yet outright bequests are not nearly as advantageous as using a trust. The best planning should probably utilize an ongoing trust ***as well as*** exploit portability, which will be discussed in the next section.

Why not just skip the burdens of an ongoing trust?[11] Here's a quick baker's dozen:

1) A trust allows the grantor to make certain that the assets are managed and distributed according to his/her wishes, keeping funds **"in the family bloodline".** Sure, spouses can agree not to disinherit the first decedent's family, but it happens all the time – people

[8] For a checklist of reasons why to use a trust and drafting and administration issues to consider if you do name a trust as beneficiary, email the author for separate CLE outline, comprehensive checklist and related articles. Also, see Sal LaMendola's excellent comparison of IRA/trust options for second marriage situations in *Estate Planning for Retirement Plan Owners in Second (or Later) Marriages - http://www.michbar.org/probate/pdfs/summer13.pdf*
[9] IRC §121, discussed further in Part VIII of this outline, page 72
[10] For S Corp qualification, including QSST and ESBT, see IRC §1361 et seq., for small business stock exclusion and rollovers, see IRC §1202 and §1045, for losses on qualifying small business stock, see IRC §1244
[11] I will avoid the probate/non-probate revocable trust debate, since probate costs and fees will vary from state to state. A bypass or marital trust might be a testamentary trust.

move away, get sick and get remarried – the more time passes, the more the likelihood of a surviving spouse remarrying or changing his or her testamentary disposition.[12]

2) Unlike a trust, assets distributed outright have **no asset protection from outside creditors** (unless, like an IRA or qualified plan, the asset is protected in the hands of the new owner) - whereas a bypass trust is ordinarily well-protected from creditors;

3) Unlike a trust, assets distributed outright have **no asset protection from subsequent spouses when the surviving spouse remarries.** Property might be transmuted or commingled to be marital/community property with new spouse. If it is a 401(k) or other ERISA plan, it might be subject to spousal protections for the new spouse (which cannot be cured via prenup, and become mandatory after a year of marriage).[13] Most states also have spousal support statutes which require a spouse to support the other - and there is no distinction if it is a second, third or later marriage. Also, most states have some form of spousal elective share statutes that could prevent a surviving spouse from leaving assets to children to the complete exclusion of a new spouse;

4) Unlike a trust, assets left outright **save no STATE estate or inheritance tax** unless a state amends its estate tax system to allow similar DSUEA elections (don't hold your breath – none have yet). This savings would be greater in states with higher exemptions and higher rates of tax, such as Washington State (20% top rate) or Vermont (16% top tax rate), both with $2 million exemptions. Assuming growth from $2 million to $3 million and a 16% state estate tax rate, that savings would be nearly $500,000!

5) Unlike a bypass trust, income from assets left outright **cannot be "sprayed"** to beneficiaries in **lower tax brackets**, which gets around gift tax but more importantly for

[12] A contract to make a will may offer a tempting solution, but there are significant problems with those that exceed the scope of this paper, such as triggering a prohibited transaction or violating the exclusive benefits rule as to retirement plan assets or disqualifying assets from marital deduction, not to mention various practical enforcement complexities

[13] See the Retirement Equity Act of 1984, IRC §401(a)(11), IRC §417(d)(1), Treas. Reg. §1.401(a)(20), Q&A 28

most families can lower overall family income tax – remember, the 0% tax rate on qualified dividends and long-term capital gains is still around for lower income taxpayers!

6) The Deceased Spousal Unused Exclusion Amount (DSUEA), once set, is **not indexed for inflation**, whereas the Basic Exclusion Amount (the $5 million) is so adjusted after 2011 ($5.25 million in 2013). The growth in a bypass trust remains outside the surviving spouse's estate. This difference can matter tremendously where the combined assets approximate $10.5 million and the surviving spouse outlives the decedent by many years, especially if inflation increases and/or the portfolio achieves good investment returns;

7) The **DSUEA from the first deceased spouse is lost if the surviving spouse remarries and survives his/her next spouse's death** (even if last deceased spouse's estate had **no** unused amount and/or made no election). This result, conceivably costing heirs $2.1 million or more in tax, restrains remarriage and there is no practical way to use a prenuptial (or postnuptial) agreement to get around it;[14]

8) **There is no DSUEA or "portability" of the GST exemption**. A couple using a bypass trust can exempt $10.5 million or more from estate/GST forever, a couple relying on portability alone can only exploit the surviving spouse's $5.25 million GST exclusion. This is more important when there are fewer children, and especially when these fewer children are successful (or marry successfully) in their own right. For example, a couple has a $10.5 million estate and leaves everything outright to each other (using DSUEA), then to a trust for an only child. Half will go to a GST non-exempt trust (usually with a general power of appointment), which can lead to an additional $5.25 million added to that child's estate – perhaps needlessly incurring more than $2 million in additional estate tax.

[14] This is not to say that prenuptial agreements should not address DSUE and portability – they should. See Karibjanian and Law, *Portability and Prenuptials: A Plethora of Preventative, Progressive and Precautionary Provisions*, 53 Tax Management Memorandum 443 (12/3/12)

9) Unlike a bypass trust, **portability requires the executor to timely and properly file an estate tax return** to exploit the exclusion, and is irrevocable once elected.[15] This may require opening a probate simply to appoint an executor.[16] This is easy for non-professional executor/trustees to overlook. The IRS is not authorized to grant exceptions or extensions for reasonable cause, though it is still open whether 9100 relief might be available if the estate value was under the threshold filing requirement (e.g. gross estate under $5.25 million);

10) Unlike a bypass trust, outright bequests cannot be structured to better accommodate **incapacity or government benefits (e.g. Medicaid) eligibility planning**;[17]

11) A **bypass trust can exploit the serial marriage loophole**. Example: John Doe dies leaving his wife Jane $5.25 million in a bypass trust. She remarries and with gift-splitting can now gift $10.5 million tax-free. If husband #2 dies using no exclusion – Jane can make the DSUEA election and have up to $10.5 million Applicable Exclusion Amount (AEA), even with the $5.25 million in the bypass trust John left her, **sheltering over $15.75 million** (three exclusion amounts, not adjusting for inflation increases) for their children without any complex planning, not even counting growth/inflation. Had John left his estate to Jane outright or in marital trust, even w/DSUEA, their combined AEA would be capped at two exclusion amounts ($10.5 million, not adjusting for inflation increases) – a potential loss of over $2 million in estate tax.[18]

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[15] IRC §2010(c)(5); Treas. Temp. Reg. §20.2010-2T(a)

[16] If there is no executor, those in possession may file, but that may be a mess for many reasons. IRC §2203. Co-executors must ALL sign the return and agree to election or it is not valid. Treas. Reg. §20.6018-2

[17] Strangely enough, there may be a difference here between a testamentary and living trust. See 42 U.S.C. § 1396p(d)(6); HCFA Transmittal 64 § 3259.1(A)(1)

[18] It appears from new regulations that DSEU has its own serial marriage loophole, though. If John left assets outright to Jane and she then gifts $5.25 million after John dies, she retains her own $5.25 exclusion, and when Husband #2 dies, she can gift another $5.25 million while retaining her own exclusion, ad infinitum.

12) Portability only helps when there is a *surviving* spouse. It may not work in a **simultaneous death** situation, whereas a bypass trust with proper funding or a simultaneous death clause imputing John as the first to die and Jane as survivor **would**.[19]

> Example: John has $8 million in assets, Jane $2.5 million. There is no community property. John believes the popular press and thinks he can rely on portability and the DSUEA to kick in and shelter their $10.5 million. But, John and Jane are in a tragic accident together. *Neither John nor Jane has a surviving spouse*. John's estate cannot elect to use $2.75 million of Jane's wasted Basic Exclusion Amount and now their family needlessly pays a tax on John's estate of **$1,100,000** ($2.75 million excess times 40%).

13) Tax Apportionment under §2207A and state law shafts the first to die's children by relying on portability. Example: H has $10 million, W has $10 million. H dies, leaving assets in a QTIP for W to "get a second step up", believing his kids are assured equal treatment and protection via QTIP - $5 million+ DSUE is ported. W dies with $10 million+ applicable exclusion amount (AEA), but $20 million estate. Approximately $4 million estate tax due (or more, depending on the state). Guess whose kids pay the tax? That's right – the first to die's kids (H's QTIP) pay ALL of the federal estate tax (and probably much more of any state estate tax if not all), not half or pro-rata as some may expect.

[19] See Treas. Reg. §20.2056(c)-2(e) – had John's will/trust had an A/B split or QTIPable trust with a simultaneous death clause stating that Jane is deemed to have survived him that would have overridden the Uniform Simultaneous Death Act and the IRS would respect the marital trust and hence add enough assets to Jane's estate to use both exemptions. When the order of death *can* be determined, you cannot simply change the order in the Will/Trust for "surviving spouse" purposes. See *Estate of Lee v. Commissioner*, T.C. Memo 2007-371. If we include a presumption that Jane dies first, will the IRS respect John as a "surviving spouse" for purposes of DSUEA? Probably, but we have no guidance yet – temporary regs do not mention this issue. Note – I have not verified whether this issue is addressed in final regulations issued in 2013 after this was written.

Part II - Using Marital Deduction Trusts and Other Options to Avoid Basis Stagnation

"*Primum, non nocere*." *First, do no harm*. – dictate from physician's Hippocratic Oath

There are other alternatives that get us closer to preserving the best basis increase and income tax result for the family. First, let's consider variations to enable/disable or limit funding of marital trusts to maximize post-mortem flexibility, then explore the variations of marital deduction trusts. Remember that a marital deduction trust, even when it would not be needed to reduce estate tax, does have the advantage of a second step up in basis at the surviving spouse's death.

Thinking Outside the "Outright Bequest v. Bypass Trust" Box: Clayton QTIP v. Disclaimer

Of course, simple outright gifts and traditional bypass trust planning are not the only two options – and they need not be "all or nothing". Disclaimer funded bypass trusts allow the surviving spouse to choose how much is allocated between those two (or more) options. The chief disadvantage of disclaimer planning is that it usually prohibits the surviving spouse from using powers of appointment for greater flexibility (see Part IV) and requires timely and proactive analysis and action (and, just as importantly, restraint) immediately after the death of a loved one. As discussed further herein, *this loss in flexibility may cost the family dearly*.

Attorneys may wish to consider a savings clause/funding variant similar to the Clayton QTIP[20] to save the use of the exclusion via bypass trust even if the Form 706 filing to claim portability is botched.[21] The Clayton QTIP/bypass trust combination may also save additional basis if the surviving spouse dies within 15 months.[22]

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[20] *Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir 1992) – decedent's Will directed that if a QTIP election was not made for a trust that the assets moved to bypass trust with *different dispositive provisions*. See also Treas. Reg. §20.2056(b)-7(d)(3) "a qualifying income interest for life that is contingent upon the executor's election under Section 2056(b)(7)(B)(v) [QTIP] will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse."

[21] **Example**: John wishes to leave his $5 million estate to his longtime wife Jane outright (ignoring all the reasons herein for ongoing trusts), but he certainly does not want to lose his exclusion amount, because his wife Jane also has a $5 million estate. His attorney therefore drafts a savings clause in his Will (or revocable trust) that leaves his available exclusion amount to a bypass trust, **but** if a proper estate tax return is timely filed to exploit the DSUEA (and the will/trust provisions may even require this, though this might give up some post-mortem flexibility), the assets instead go outright to his wife to the extent of the election. Thus, if the executor files the Form 706 timely and successfully "ports" $5 million DSUE, then $5 million goes outright. If the executor fails to timely file the Form 706 (or opts out), then $5 million goes into a liberal bypass trust for Jane. Either way, the exclusion is

Example: John dies leaving $1.25 million IRA outright and $4 million in non-IRA assets to his wife Jane in trust. To the extent a QTIP election is not made, the $4 million will go into a flexible bypass trust. If the QTIP election is made, the $4 million will go into a QTIP trust for Jane. Jane dies a year later with $5 million of her own assets (including the rollover IRA), and John's trust has since appreciated to $5 million. John's estate makes the QTIP election and elects to port all $5.25 million DSEU, Jane's estate includes her $5 million, plus the $5 million QTIP, and the entire estate receives a new basis (absent IRD/IRA assets etc). Conversely, John's executor would **not** make the QTIP election had the market dipped and John's trust *depreciated* to $3 million, to save the estate from a "step down" in basis.

Clayton QTIP arrangements have the added benefit over disclaimer funded trusts of permitting limited powers of appointment, as well as the six months of additional window of opportunity. Moreover, they do not have dicey acceptance and control issues as with qualified disclaimer rules, nor the potential for fraudulent transfer, Medicaid or tax lien issues affecting disclaimants.[23] Parties often assume joint brokerage accounts, for instance, can easily be disclaimed but tracing who contributed the funds may be crucial to disclaiming such accounts.[24] However, Clayton QTIP arrangements are best made with an independent executor, whereas the identity of the executor with disclaimers is completely irrelevant.

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saved. An independent executor/trustee may be desired here. A surviving spouse would have obvious conflicts with his or her fiduciary duties to other beneficiaries by filing such an election and potentially gift tax issues as well, unless the filing were mandated in the document (in this example that may be best). Even if an independent party is named, it may be best to outline parameters or indemnify the executor from diverse ranges of elections selected.

Drafting Example: "I leave my entire residuary outright to my surviving spouse, on the precondition that my personal representative (or my trustee if no personal representative is appointed, pursuant to IRC § 2203) makes an effective election on an estate tax return pursuant to IRC §2010(c) to grant my spouse the use of my Deceased Spousal Unused Exclusion Amount. Should for any reason (intentional or unintentional), such an election is not effectively made, or is made for less than maximum amount available, I hereby leave the maximum amount possible without incurring a federal estate tax to the Bypass Trust described in Paragraph __, and any remaining residuary above this amount shall pass to my surviving spouse outright". [I hereby indemnify my executor from any such election or failure to elect (be it partial, to the maximum extent or not made at all) made in good faith.] [NB: fractional formula variations on this would be desirable if IRD is involved].

This technique would be difficult to use for non-probate, non-trust assets such as qualified plans, IRAs etc.

[22] As discussed in the next Part II, page 15, QTIPs elections can be made on a late return, but since DSUEA requires a timely filed 706, it is recommended that timely Forms 706 be filed for any substantial estates.

[23] Some states do not buy into the "relation back" myth that a disclaimer is not a transfer of a property interest subject to fraudulent transfer laws (Ala Code § 43-8-295; Fla. Stat. Ann. § 732.801(6); §739.402(d); Mass. Gen. Laws Ann. 191A § 8; Minn. Stat. Ann. § 525.532(6); N.J. Rev. Stat. Ann. § 3B:9-9; and Wash. Rev. Code Ann. § 11.86.051, *In re Kloubec* 247 BR 246, (2000, Bk. ND Iowa), *Lowe v Brajkovic* (1993, Bk WD Tex) 151 BR 402 (list not shepardized for current status). Ohio recently legislatively overruled an adverse court decision (*Stein v Brown*). Disclaimers cannot avoid tax liens. *Drye v. United States*, 528 U.S. 28 (1999)

[24] Treas. Reg. §25.2518-2(c)(4)(iii), even though IRC §2040(b) would deem 50% to be in each spouse's estate

Extreme, but not uncommon, scenarios such as this could save hundreds of thousands of dollars in basis by building flexibility into the plan. Even a heavy bond portfolio (approximately 10 yr duration) could easily decrease in value 25% if interest rates went up a couple percentage points.[25] *Practitioners should file for a six month extension on Form 706 even if no estate tax would be due to buy additional time*, even if one of the preferred Optimal Basis Increase Trust design options, discussed in Part III, is utilized.

Variations in Marital Trusts – Drawbacks to Using GPOA and QTIP Trusts

Aside from the potential *state* estate tax deferral/savings, marital trusts receive a second step up in basis without sacrificing the asset protection and control of a trust. Succeeding trusts/beneficiaries generally receive a new basis when assets are in the surviving spouse's estate in a general power of appointment (GPOA) marital trust or a qualified terminal interest property (QTIP) marital trust.[26]

The QTIP marital trust can be more restrictive at second death than a GPOA marital trust, by restricting or even eliminating the surviving spouse's power to appoint.[27] Because of this and other advantages, QTIPs are by far the most preferred.[28] However, especially in smaller estates of couples with children of the same marriage, and states with no state estate tax, ***the GPOA marital trust may see a rise in popularity*** because couples with smaller estates don't need to file a Form 706 to get the second step up in basis and won't get hit with additional valuation discounts hampering basis increase.

Example: John and Jane, married, in their mid 70s, have less than $1 million each. They wish to leave assets in trust to each other for all the various non-tax reasons herein, but want to preserve the second step up in basis at the second death. Using a QTIP design requires the first decedent's executor to file a costly Form 706 with the appropriate QTIP election - otherwise, it's no different than a bypass trust, and won't get a step up in basis at the second spouse's death. However, using a GPOA marital trust does not require such a

[25] http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P204318 - 2% or more jumps happened several times in the late 70s, early 80s.
[26] IRC §1014(b)(6),(9), (10). There is also a less common "estate trust" which is even less commonly used.
[27] At IRC §2056(b)(7) and IRC §2056(b)(5) respectively
[28] If the GPOA does not bother a client for non-tax reasons, most of the other advantages, like reverse QTIP and optimizing GST, flexible use of previously taxed property credit if deaths are close together in time or valuation discounts, really only apply to larger taxable estates – irrelevant to more than 99% of the population now.

filing. Even if *no* Form 706 is filed at the first death, assets in the GPOA marital get a new adjusted basis at the second death.[29]

Moreover, GPOA trusts may also be preferred for taxpayers in the 99% who would fund a portion of real estate or fractional interests in LLCs/LP/S Corps, e.g., into trust.

> Example: John and Jane, in the example above, plan to fund their trust with their 50% interest in a home, total value $600,000 and 50% of rental property LLC, underlying asset value $500,000. If a QTIP is used, the surviving spouse's estate must value the ½ in the QTIP and the ½ in the surviving spouse's estate separately, generating a fractional interest, and/or marketability, non-controlling interest "discount".[30] At second death, these "fair market values" might total $500,000 and $300,000 respectively, rather than $600,000 and $500,000 (an LLC would probably have a greater discount than a 50% tenancy in common interest). This reduction in valuation would be optimal planning *if* Jane had a taxable estate, but **for most people**, ***"discounting" will save no estate tax and cost the heirs significant basis increase*** – for Jane and John's family, $300,000. Had the 50% interest in the home and 50% LLC interest gone to a GPOA marital trust for the survivor, the two halves would be valued together for estate tax at the second death, and therefore retain full FMV of basis.[31]

There may be a solution for this, although many practitioners will find it odd and counterintuitive at best – use a formula general power of appointment designed to pull such assets into the estate under 2041 rather than 2044 to accomplish consolidation for valuation purposes. Such a power would be designed not to qualify the trust under IRC §2056(b)(5), yet be permitted to be retained under IRC §2056(b)(7).[32]

GPOA trusts may also be preferred for taxpayers in states such as New York and New Jersey that do not permit a separate state QTIP election.[33]

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[29] Under IRC § §1014(b)(9), not IRC §1014(b)(10)
[30] See, e.g. *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999), acq. 1999-2 C.B. 314, *Estate of Chenoweth*, 88 T.C. 1577 (1987), *Estate of Ambrosina Blanche Lopes v. Comm.*, T.C. Memo 1999-225 (tenancy in common).
[31] See, e.g. *Estate of Fontana v. Commissioner*, 118 T.C. 318 (2002), IRS FSA 200119013, interpreting Treas. Reg § 20.2031-1(b) - unlike a QTIP, a GPOA marital trust is consolidated with spouse's estate for valuation purposes. See IRC §754 for inside basis election for partnership/LLCs.
[32] See footnotes 31 and 32 above, IRC §2056(b)(7)(B)(ii)(II) specifically permitting spouse a testamentary POA
[33] See, *The General Power of Appointment Trust is Back*, Bruce Steiner, LISI Estate Planning Newsletter #2060 (February 6, 2013).

Another reason marital GPOA trusts might be preferred for taxpayers with estates under the applicable exclusion amount is the potential threat posed by IRS Rev. Proc. 2001-38. Rev. Proc. 2001-38 outlines a procedure to permit taxpayers and the IRS to disregard a QTIP election, even though the election is irrevocable, under certain circumstances. It was clearly designed to help taxpayers who unnecessarily over-qtipped what should have remained a bypass trust. There is no indication yet that the IRS will use it as a weapon of attack, against a taxpayer's interests, yet it does purportedly allow them to "disregard the [QTIP] election and treat it as null and void for purposes of sections 2044(a), 2056(b)(7), 2519(a) and 2652."[34] Since the basis rules under IRC §1014(b)(10) reference inclusion via IRC §2044, this would be a problem in preserving a second basis increase, because denying the QTIP election would deny inclusion under IRC §2044, and hence deny the new basis. This unilateral Rev. Proc. should not entitle the IRS to retroactively disregard a validly made statutorily granted QTIP election on their own accord.

However, until the IRS issues further guidance, some practitioners may prefer to avoid the issue altogether and use a marital GPOA (or use intervivos QTIPs, to which the Rev. Proc. does not apply if your state has fixed other intervivos QTIP problems).[35] This will depend on whether a GST/reverse QTIP election would be used, the compatibility of the estate plan with powers of appointment and other factors. QTIPs will probably remain the preferred vehicle for potentially estate taxable estates. Ultimately, the IRS will probably modify the Rev. Proc. not only to clarify this point, but to prevent other obvious abuses of the procedure.[36]

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[34] IRS Rev. Proc. 2001-38, see also PLRs 2009-18014, 2007-29028, 2010-36013, voiding valid QTIP elections

[35] The problem with inter-vivos QTIPs is that, after the death of the donee spouse, if assets come back to the donor spouse in trust, even though IRC §2044(c), Treas. Reg. §25.2523(f)-1(f), Example 11 would deem the donee spouse the grantor/transferor for 2036/2038 purposes, under most state laws, the donor spouse is still the settlor, making the trust self-settled and therefore subject to the donor's creditors despite any discretionary standard or spendthrift provision, and therefore in the donor spouse's estate indirectly under IRC §2041. See also Rev. Rul 76-103. States that have recently fixed this issue are Arizona (Ariz. Rev. Stat. 14-10505(E)), Michigan (MCL §700.7506(4)), Virginia (Va.Code 55-545.05(B)), Ohio (Ohio R.C. §5805.06(B)(3)(b)), Delaware (12 Del Code 3536(c)(2), Florida (Fla Stat. 736.0505(3)) , Texas (Code §112.035(g))

[36] For example, the income tax/basis play if the surviving spouse dies after a "market correction", be it the bond market, stock market, real estate market, etc. Say when the surviving spouse dies the QTIP is worth $3 million, with basis $4 million. The QTIP election wasn't needed, isn't desired with 20/20 hindsight, it was made purely on assumption that basis would increase by the second death. If it does not, can the surviving spouse's executor simply "undo" the QTIP election pursuant to Rev. Proc. 2001-38, restoring $1 million basis? This assumes this Rev. Proc. is not amended. There may be state estate tax ploys too.

Thus, marital trust planning can combine the income tax basis benefit of the outright/portability option with the estate preservation and the asset protection planning advantages of a bypass trust. Marital trusts can solve the first major drawback of the bypass trust discussed above - basis, and can solve *most* of the twelve drawbacks of outright planning discussed in Part I above.

But we might do even better. After all, marital trusts typically don't solve the higher ongoing income tax issue, and are problematic in that they also receive a second step ***down*** in basis. Moreover, they cannot spray income as a bypass trust could and they are leaky for both asset protection and tax reasons, because of the mandatory income requirement. They provide greater complications for see-through trust status (aka "stretch IRAs"), especially for GPOA marital trusts. They cannot use broad *lifetime* limited powers of appointment – which can be important for gifting and income tax planning techniques discussed in Part VIII.[37] They cannot be used by non-traditional couples who are not officially recognized as "married."[38] Furthermore, they simply won't be as efficient in saving state estate taxes or federal estate taxes, especially if the surviving spouse does live long and assets appreciate significantly, since the DSUEA amount is not indexed for inflation.

What ways other than using marital deduction trusts could we achieve a second step up in basis at the surviving spouse's death on assets in a bypass trust?

We could build greater flexibility to accomplish the same goals by either:

1) giving an independent trustee (or co-trustee, or "distribution trustee") discretion to distribute up to the entire amount in the bypass trust to the surviving spouse;

2) giving an independent trustee or trust protector the power to add general testamentary powers of appointment, or effecting the same via decanting or other reformation under state law if enough trustee discretion is granted;

3) giving another party (typically a child, but it could be a friend of spouse or non-beneficiary), a non-fiduciary limited lifetime power to appoint to the surviving spouse;[39]

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[37] IRC §2056(b)(7)(B)(ii)

[38] After the Supreme Court struck down Section 3 of the Defense of Marriage Act (DOMA) recently in *Windsor* and the IRS issued Rev. Rul. 2013-17, same sex couples in a legally recognized marriage will now get the marital deduction. However, this does not include registered domestic partners or similar statuses.

[39] This is known as a collateral power, See *Restatement Property*, *Third*, *Donative Transfers*, §17.3, comment f

4) if the trust otherwise qualifies, and no return was ever filed to **not** make a QTIP election, try to file a late Form 706 and make a late QTIP election.

5) giving the surviving spouse a limited power to appoint, but enabling the appointment to trigger the Delaware Tax Trap over the appointed assets;[40]

6) giving the surviving spouse a limited power to appoint that alternatively cascades to a general power to the extent not exercised.[41]

7) giving the surviving spouse a general power to appoint appreciated non-IRD assets up to the surviving spouse's remaining applicable exclusion amount.

This article will focus on the advantages of the last three of these, referred to as an Optimal Basis Increase Trust. The problem with the first two above techniques, which involve placing the burden on the trustee or trust protector, is that they are often impractical and *require an extraordinary amount of proactivity and omniscience, not to mention potential liability for the trustee/trust protector*. Gallingly, clients don't tell us when they are going to die, hand us accurate cost basis and valuation statements, marshal beneficiary agreement and give us enough time to amend, decant or go to court to change the estate plan to maximize tax savings. Furthermore, fiduciaries taking such drastic steps are likely to wish to hire counsel, get signed waivers, or consult a distribution committee – time for which may be scarce in a situation where the surviving spouse is hospitalized or terminally ill.

Distributing assets outright to the surviving spouse, even if clearly under the authority of the trustee, protector or donee of a power of appointment, risks losing the asset protection for the family and risks a disinheritance or removal outside in the family bloodline. If the distribution is arguably beyond the trustee's authority (e.g. the distribution standards are only for "health, education and support"), even with children's consent, the IRS may see it as

[40] IRC §2041(a)(3), IRC §2514(d). While it's very simple to add a LPOA that would in theory permit this, understanding the DTT involves considerable complexity. Michigan and Ohio have recently amended their Rule Against Perpetuities to specifically prevent most unintentional triggerings of the "trap", but clearly permit intentional triggerings by appointing to a trust that has a presently exercisable *general* power of appointment and therefore triggering IRC §2041(a)(3). See Ohio R.C. §2131.09, and a comprehensive article on the subject from Attorney James Spica regarding Michigan's RAP at http://www.michbar.org/probate/pdfs/Summer08.pdf

[41] A rather clever variation that the IRS fought, lost and finally acquiesced to in *Chisholm v. Commissioner*, 26 T.C. 253 (1956), but beware Restatement of Property, Second, Donative Transfers §13.1(c), which would deem any LPOA to be a GPOA if the gift in default of exercise were to pass to the powerholder's estate.

collusion to avoid tax.[42] Plus, we've all heard cases of someone on death's door that miraculously makes a full recovery and lives another decade or more. Once the assets are out of trust, you can't simply put them back in and be assured the same tax results.

Adding a general testamentary power of appointment does not have the same level of risk, nor the same destruction of asset protection from outside creditors, as an outright distribution.[43] Some trusts will have a trust protector provision that allows this, and several states have a decanting statute that allows GPOAs to be added if there is enough discretion.[44] However, it merely begs the question – *if it's worth doing later, why isn't it worth doing now before it's too late*?

Leaving the ability for a trust protector to add GPOA basis savings clauses later is like GM or Toyota deciding to leave a space for air bags and seat belts and telling people they can always go back to a mechanic to add them later.

Distinguished expert presenters have cautioned against giving non-adverse parties such as trust protectors, trustees or trust advisors the ability to add GPOAs (beyond what state law already grants in the trust code, decanting statute, etc).[45] The reason is that this may be deemed to be a general power of appointment over the entire trust in itself. Consider this: if spouse has a GPOA only exercisable with consent of a trust protector (assume the TP is not a child or remainderman, which is highly likely), we know this is still a taxable GPOA because the consenting party is non-adverse.[46] Is this so different from a non-adverse party (trust protector) being able to add a GPOA with consent of the spouse? Both variations allow a GPOA to be exercised only with the consent of the spouse and trust protector. Could this be merely a semantic difference?

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[42] E.g. in *McCombs v. United States*, 248 F. Supp. 568 (W.D. Ky 1965), widow/children tried to argue that widow had a GPOA to qualify for marital estate tax deduction, and even went to state court and distributed the entire trust to the widow outright. Despite the state court decree, the fed court denied the marital deduction, because the trust did not authorize her to receive outright or GPOA equivalent rights – could the IRS use a similar argument re income tax? I think so, unless state law to terminate the trust is strictly followed.

[43] See *Restatement of Property, Second, Donative Transfers*, §13.2 *Creditors of the Donee - Unexercised General Power Not Created by Donee.* If creditor protection is a potential threat, and state law is unfavorable, consider the LPOA/DTT variant (assuming of course, state law easily allows triggering the trap).

[44] E.g. Ohio, http://www.actec.org/public/Documents/Studies/Bart_State_Decanting_Statutes_11_18_13.pdf

[45] *Identifying and Respecting the Core Elements of a Modern Trust*, Ronald Aucutt, 48th Annual Heckerling Institute on Estate Planning ¶1305.1[B]

[46] IRC §2041(b)(1)(C)(ii)

Is this substantially different from an independent trustee with the discretion to pay the entire amount of a trust to a spouse or other beneficiary? Non-beneficiary holders of lifetime limited powers of appointment? Since the trustee or powerholder in these scenarios is non-adverse, isn't this also like the spouse and non-consent party together having a GPOA? When we look at it this way, we probably see some absurdity and instinctively feel the answer must be NO – else the IRS would have long since hammered thousands of trusts with estate inclusion. Would it matter if the trust protector or other advisor is considered a fiduciary and held to fiduciary duties in his or her ability to add a GPOA? Some attorneys and state law allow trust protectors/advisors to be considered *non-fiduciaries*.

To summarize, while it may not be a strong IRS argument, why tempt it? If you allow a trust protector or other party to grant a beneficiary a GPOA, limit the potential amount of appointive assets in the same manner as discussed in the following section.

The third technique, using a limited lifetime power of appointment, simply moves the burden to someone other than the trustee, and may lead to many difficult issues even in traditional families. A lifetime limited power to appoint could be made conditional upon unanimous consent of the children, but this of course brings up the possibility of one child's obstinance holding back the family's tax planning.

The 4th technique above, making a late QTIP election, may surprise people. Some bypass trusts might qualify as a QTIP with the proper election (e.g. if spouse is sole beneficiary during his or her lifetime and entitled to demand/receive all net income). A QTIP election can be made on the last timely filed estate tax return, or, *if no timely return is filed, on the first late return.*[47] This might be a full or, perhaps better for Rev. Proc. 2001-38 reasons, partial election. You need not reopen a probate estate to appoint an executor, the trustee may file.[48] If estate administration is finished, it may be too late to divide a trust subject to partial election into two separate trusts for optimal efficiency.[49] Conceivably, the trustee could even wait until after the death of the *surviving* spouse so that the QTIP election "relates back" to cause inclusion in the surviving spouse's estate to seize the additional step up in basis. This

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[47] Treas. Reg. §20.2056(b)-7(b)(4)(i). Be careful using this for state estate tax planning, some states (formerly, this was the case in Ohio) may not follow federal law to allow a late filing for a state-equivalent QTIP.
[48] Treas. Reg. §20.2056(b)-7(b)(3)
[49] Treas. Reg. §20.2056(b)-7(b)(2)

could cause serious headaches with a Clayton QTIP arrangement. More importantly, however, *planning for a late QTIP election is simply not a viable proactive planning technique because failing to timely file a Form 706 eliminates, or at best jeopardizes, portability*.

So, how do we better ensure that assets get the maximum step *up* possible, not a step *down*, don't cause extra state estate tax (or federal), and achieve better ongoing income tax treatment and asset protection than a typical bypass or marital trust, without the above drawbacks?

Let's turn to the final three methods above, which use formula powers of appointment to allow for firmer and more precise tax planning. I will refer to all of these variants together as an Optimal Basis Increase Trust (OBIT).

Part III - The Optimal Basis Increase Trust (OBIT)

"Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands."
- Judge Learned Hand, *Gregory v. Helvering*, 69 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935)

Using testamentary general and limited powers of appointment more creatively can assure that assets in the trust receive a step *up* in basis, but not a step *down* in basis, and these powers can be dynamically defined or invoked so as to not cause additional estate tax.

Example: John Doe dies in 2013 with $2Million in assets left in trust for his wife Jane. She files a Form 706 and "ports" $3.25 million DSUE. We'll assume that most of this gain has been realized, though with more tax efficient or buy/hold strategy, realization may be less. After 8 years, when she dies, these trust assets have grown to $4 million, as follows:

Traditional deductible IRA[50]	basis $0,	FMV $700,000
Total "IRD" Property	basis $0	FMV $700,000
Apple Stock (the iPhone 9 flopped),	basis $500,000,	FMV $200,000
Condo in Florida (hurricane depresses value),	basis $1,000,000,	FMV $600,000
LT Bond portfolio (inflation depressed value)	basis $400,000	FMV $300,000
Various stocks that have decreased in value	basis $150,000,	FMV $100,000
Total "loss" property	basis $2,050,000,	FMV $1,200,000
Rental Real Estate[51]	basis $200,000,	FMV $600,000
Various stocks that have increased in value	basis $400,000,	FMV $900,000

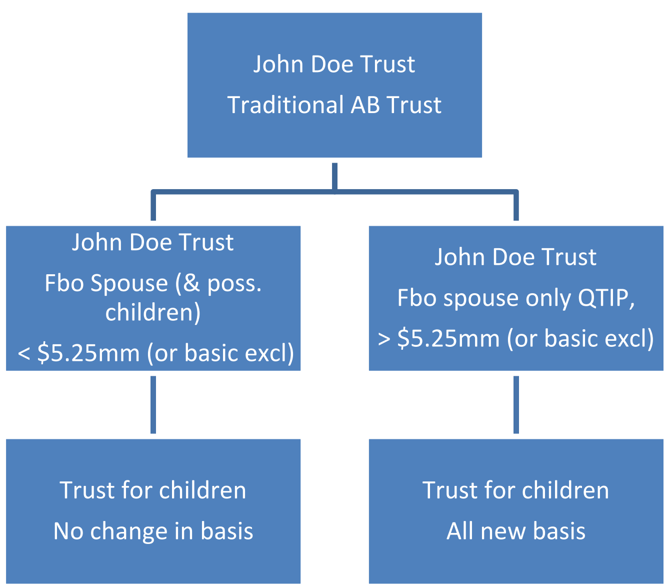
[50] In many cases, I would not recommend that an IRA be used to fund a bypass trust, since a spousal rollover has better income tax treatment, but it may be preferable when needed to soak up state estate tax exemption, or for various non-tax reasons. This is mostly included to show the lack of effect on basis on IRD at death. If an accumulation trust (as opposed to conduit trust) design is used, consider a separate or standalone trust so that no broad power to appoint can be construed to apply to the retirement benefits. Blanket savings clauses may not save the stretch, especially since most POAs by default can include non-qualifying trusts. See *Restatement of Property, Third, Donative Transfers* §19.14, other IRA CLE and checklist materials developed by author and ¶6.3.09, *Life and Death Planning for Retirement Benefits*, 6th Edition, by Natalie Choate.

[51] If real estate is held in an LLC/LP or other entity taxed as a partnership, the underlying assets do not automatically get a date of death basis even if the LLC/LP is in the decedent's estate, but the partnership may make an election under IRC §754 to step up inside basis. Treas. Reg. §1.754-1. And where are the articles explaining how to REDUCE discounts to FLPs/FLLCs by amending operating agreements (put rights, etc)? I've read multiple articles stating essentially "you can just reduce the discount you take", which is *absolute nonsense*.

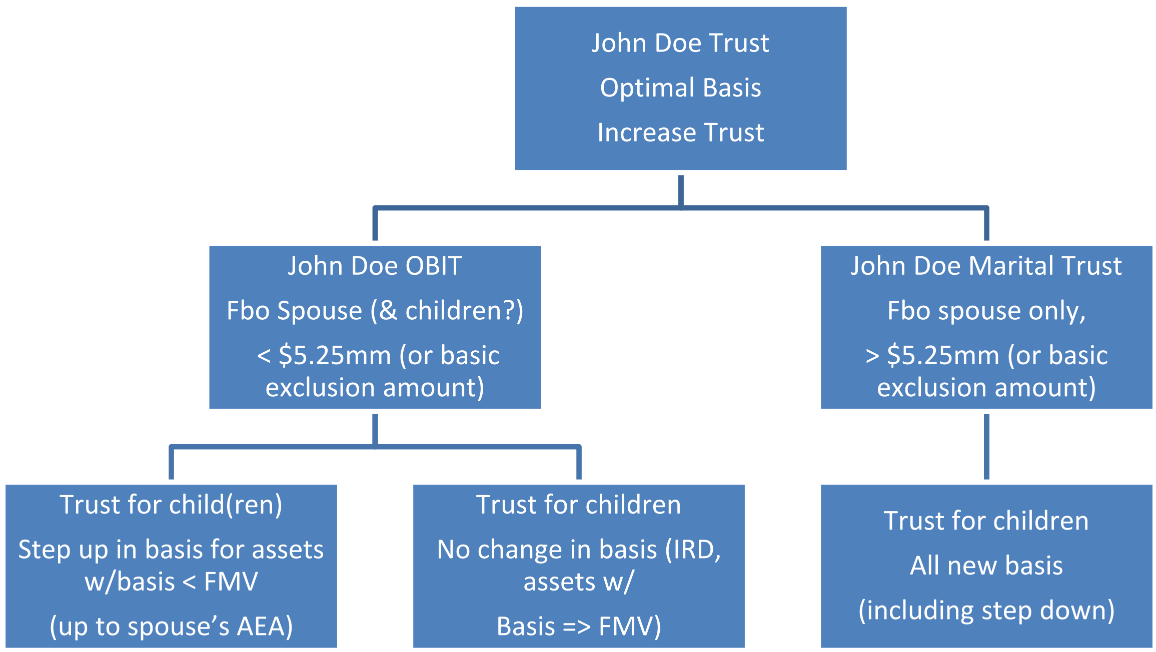
ST Bond Portfolio, Money market, Cash	basis $400,000, FMV $400,000
Gold	basis $100,000 FMV $200,000
Total "gain" property	basis $1,100,000, FMV $2,100,000
Total at Jane's death	basis $3,150,000 FMV $4,000,000

Had John used an outright bequest, or a marital trust, all of the assets above (except the IRA) would get a new cost basis – including the loss properties.[52] Had John used an ordinary bypass trust, none of the assets above would get a new cost basis, including $1 million of unrealized gains (see chart below)!

Instead, John's Optimal Basis Increase Trust (OBIT) grants Jane a *limited* power of appointment (or no power at all) over all IRD assets and assets with a basis higher than the fair market value at the time of her death (total assets $1.9 million). It grants Jane a *general* power of appointment ("GPOA") over any assets that have a fair market value greater than tax basis (total assets $2.1 million). As discussed below, this may also be accomplished with a limited power of appointment ("LPOA") that triggers the Delaware Tax Trap.



[52] Potentially, the QTIP may be worse than an outright marital transfer if there is no estate tax, since you may have discounting if, for instance, a QTIP owns half the home and the surviving spouse owns half – this would result in less basis for remaindermen than if the surviving spouse had owned the whole.



Step up caused by formula
GPOA or LPOA and §2041(a)(3)

New Basis at Surviving Spouse's Death if using:	**Ordinary Bypass**	**QTIP/outright**	**OBIT**
Traditional deductible IRA	$0	$0	$0
Apple Stock (the iPhone 9 flopped),	$500,000	$200,000	$500,000
Condo in Florida (hurricane depresses value),	$1,000,000	$600,000	$1,000,000
LT Bond portfolio (inflation depressed value)	$400,000	$300,000	$400,000
Various stocks that have decreased in value	$150,000	$100,000	$150,000
Rental Real Estate	$200,000	$600,000	$600,000
Various stocks that have increased in value	$400,000	$900,000	$900,000
ST Bond Portfolio, Money market	$400,000	$400,000	$400,000
Gold	$100,000	$200,000	$200,000
Total Basis for Beneficiaries at Jane's death	**$3,150,000**	**$3,300,000**	**$4,150,000**

Result: John and Jane Doe's beneficiaries get a step up on the trust assets, but, more uniquely, do not get a "step down" in basis for any loss property (in our example, new basis is $4,150,000 versus $3,150,000 had a standard bypass trust been used and only $3,300,000 of basis had a marital trust been used. *That's a lot of savings*. The beneficiaries (through a continuing trust or outright) get a carry over basis over any assets received via limited power of appointment (or received by default if such assets were not subject to a general power of appointment at death). This allows them to use the higher basis for depreciable assets to offset income, or sell assets to take the capital loss to offset other capital gains plus $3,000/yr against ordinary income, or hold for future tax-free appreciation up to basis.

Think people won't die with unrealized capital losses? It happens all the time. Ask anyone who handled an estate in 2008-2009. It is a dangerous misnomer to call the basis adjustment at death a "step up" without realizing it's equally a "step down" when assets don't appreciate as we had wished them to, yet we are all guilty of this pollyannaish shorthand. Increasing trust capital gains tax rates, discussed in more detail in Part II and VIII, may cause more tax sensitivity, meaning more use of individually managed bonds and equities or at least low-turnover funds or ETFs in order to decrease turnover and gains realization, which may mean even more unrealized gains in future irrevocable trusts.

Why haven't people done this before? Besides the frustrating instability of the transfer tax regime and the smaller exemptions prior to EGTRRA, there are two main reasons: if not properly curtailed with careful drafting, it could increase estate tax exposure and decrease testamentary control by the first spouse to die. Solutions for these two issues will be discussed below. Regarding the first reason, we need to wake up and smell the new paradigm. What percentage of the population cares about the estate tax now, even with some assets included in both estates?

Let's revisit our example above. Let's say Jane has $3 million of her own assets. Her DSUE from her late husband John was $3.25 million (frozen, not adjusted for inflation), and her own basic exclusion amount is $6.25 million ($5.25 million plus 8 years of estimated inflation adjustments adding $1 million more). Even if she had missed the Form 706/portability filing, adding $2.1 million to her estate doesn't even come close to her $9.5

million applicable exclusion amount. But what if Jane wins the lottery and has $9 million in her estate without John's trust? Could this type of trust provision cause $640,000 of additional estate tax ($9 million plus $2.1 million, minus $9.5 million AEA, times 40% rate)?

Fortunately, John's Optimal Basis Increase Trust includes a formula. The GPOA is only applicable to those assets to the extent it does not cause increased federal estate tax (and takes into account state estate tax, discussed further below). Powers of appointment can be limited in scope as to either appointees or assets. Many existing trusts already have GPOAs over only a portion of the trust (typically, the GST non-exempt share). There is no reason one cannot grant a general power of appointment over less than 100% of trust assets, or by formula.[53] All of our traditional planning has A/B/C, GST formulas that the IRS has blessed and this should be no different.[54] You can select assets specifically subject to the power (e.g. an asset that you know the next generation will sell), or carve out assets not subject to the power (e.g. an asset that you know the next generation will not sell).

Furthermore, the appointment could be applicable to the assets with the greatest embedded gain to satisfy this amount. The drafting difficulty is not so much in capping the GPOA but in creating the ordering formula and adjusting for individual state estate taxes.

Let's take the non state-taxed situation first. In our lottery scenario above, Jane's estate has only $500,000 of applicable exclusion to spare, but the appreciated "stepupable" assets of the OBIT total $2.1 million. Which assets should be stepped up first?

Assets that may incur higher tax rates, such as collectibles (artwork, antiques, or gold, in the example above) 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

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[53] Treas Reg. §20.2041-1(b)(3) states that "(3) Powers over a portion of property. If a power of appointment exists as to part of an entire group of assets or only over a limited interest in property, section 2041 applies only to such part or interest." There are probably dozens of cases and rulings about limiting powers and funding trusts with "caps" - a few in the GPOA context are PLR 2001-23045, 2000-101021, 2002-10051, 2004-03094, 2006-04028

[54] Formulas tied to tax exemption have always been used for AB/GST funding, and even formula gifts designed for specific tax results have had recent success in the *Wandry*, *Petter* and *Christiansen* line of cases, but there are good examples even in Treasury guidance. See Treas. Reg. §25.2518-3(d), Example (20) in the area of qualified disclaimers: "A bequeathed his residuary estate to B. B disclaims a fractional share of the residuary estate. Any disclaimed property will pass to A's surviving spouse, W. **The numerator of the fraction disclaimed is the smallest amount which will allow A's estate to pass free of Federal estate tax and the denominator is the value of the residuary estate.** B's disclaimer is a qualified disclaimer." An OBIT formula is the same concept applied to powers of appointment - would the IRS dare to fight against such similar Treasury guidance? See also A/B formulas in Rev. Rul. 64-19, Treas. Reg. §26.2632-1(b)(4) (GST formula allocation).

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

Some of this analysis will sound similar to those who handled estates of those who died in 2010 when the price to pay for no estate tax was a limited step up in basis. While the concept *sounds* similar, in practice, it is quite different. In 2010 the executor could choose assets to apply a set quantity of basis to, pursuant to specific statute.[55] Ideally, we would like to give Jane's executor or the trustee the power to choose the assets to comprise the $500,000 of appointed assets – in both drafting and in practice that is deceptively simple. However, this is quite different from 2010 carry over/step up law, and different from "pick and choose" formula funding.

If the power of appointment is deemed to apply to a pecuniary amount (here, $500,000), rather than a fractional formula (500,000/2,100,000), it may have undesired income tax consequences upon funding.[56]

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[55] IRC §1022

[56] See IRS Chief Counsel Memorandum (CCM) 200644020 regarding IRD assets. Also see Treas. Reg. §1.1014-4(a)(3): "Thus, for example, if the trustee of a trust created by will transfers to a beneficiary, in satisfaction of a specific bequest of $10,000, securities which had a fair market value of $9,000 on the date of the decedent's death (the applicable valuation date) and $10,000 on the date of the transfer, the trust realizes a taxable gain of $1,000 and the basis of the securities in the hands of the beneficiary would be $10,000. As a further example, if the executor of an estate transfers to a trust property worth $200,000, which had a fair market value of $175,000 on the date of the decedent's death (the applicable valuation date), in satisfaction of the decedent's bequest in trust for the benefit of his wife of cash or securities to be selected by the executor in an amount sufficient to utilize the marital deduction to the maximum extent authorized by law (after taking into consideration any other property qualifying for the marital deduction), capital gain in the amount of $25,000 would be realized by the estate and the basis of the property in the hands of the trustees would be $200,000. If, on the other hand, the decedent bequeathed a fraction of his residuary estate to a trust for the benefit of his wife, which fraction will not change regardless of any fluctuations in value of property in the decedent's estate after his death, no gain or loss would be realized by the estate upon transfer of property to the trust, and the basis of the property in the hands of the trustee would be its fair market value on the date of the decedent's death or on the alternate valuation date." and Treas. Reg. 1.661(a)-2(f): "(f) Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e). This paragraph applies for taxable years of trusts and estates ending after January 2, 2004." Presumably the result here would not be too

Thus, we should avoid simple powers of appointment over, for example, "an amount of assets equal to my spouse's remaining applicable exclusion amount".

If Jane's testamentary power potentially extends to all of the applicable property equally ($2.1 million), only limited to $500,000, all property subject to that provision should get a fractional adjustment to basis accordingly – no different than if a child dies at age 36 and had a power to withdraw 1/3 of corpus at age 35 and did not take it – all assets would get a 1/3 basis adjustment.[57] A pro rata adjustment would lead to wasted basis, since a $1,000,000 asset with $1 gain would soak up the same applicable exclusion amount as a $1,000,000 asset with $900,000 gain. This would be better than no extra basis at all, but not as optimal as the trustee limiting the powerholder's general power, or, more conservatively, establishing an ordering rule to determine exactly which property the power pertains to.

The trustee might be given a fiduciary limited power of appointment to choose the appointive assets subject to the beneficiary's testamentary GPOA. Black letter law defines a power of appointment as "a power that enables the donee of the power to designate recipients of beneficial ownership interests in or powers of appointment over the appointive *property*."[58] Arguably, a trustee with such a power would be the donee of a fiduciary limited power of appointment to designate recipients of powers of appointment over the appointive property.[59] If the trustee is independent, this could arguably limit the spouse/donee'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 AB funding formulas that involve trustee choice, the IRS may try to apply a "fairly representative" requirement anyway.[60] Thus, it is probably more conservative and simpler in concept to simply make clear the GPOA never applies to the less appreciated assets, and is never subject to any powerholder's discretionary choice.

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harsh, since assets would get a step up in basis at death and hence less gain, but executing the appointment transfer may take place months after death, by which time assets might have appreciated significantly. Best to avoid the issue and have it apply to specific assets based on date of death or AVD value.

[57] If the power to withdraw 1/3 had lapsed, 5% might be "lapse protected", causing slightly less to be in the beneficiary's estate (and thus less basis adjustment).

[58] *Restatement, Third, Property, Wills and Other Donative Transfers* §17.1

[59] See comment g in *Restatement, Third, Property, Wills and Other Donative Transfers* §17.1

[60] Rev. Proc. 64-19, which has to do with post-mortem gains/losses when distributing in kind based on DOD value

So, in our example, the trust provides that the GPOA applies to the most appreciated asset first, cascading to each next individual asset until $500,000 in total property is reached. In our case, the real estate has the greatest appreciation (assuming there is not a more appreciated stock in "various stocks" category), thus the GPOA would apply to 5/6 interest (be it % as tenant in common, or more likely, % LLC membership interest). Thus, the basis would be increased to FMV on the date of Jane's death as to 5/6 of the property (5/6 times $600,000, or $500,000) and the remaining 1/6 would retain its carry over basis (1/6 of $200,000, or $33,333).[61] This means a basis increase from $200,000 to $533,333. This method could easily make for a rather extensive spreadsheet when dealing with many dozens of individual stock positions, but it's less burdensome than what 2010 executors had to deal with for carryover basis.

In our ordering example, the GPOA could never apply to the less-appreciated assets, and hence the IRS would have no statutory basis to include them in Jane's estate (or accord them an adjusted basis). It applies to specific property, not a dollar amount or a fraction (though it could apply to say, 34 of 100 shares, etc). If the most appreciated property is family business stock, that's what it applies to, and there is no discretion in the trustee or the powerholder to change the appointive assets subject to the GPOA. While this gives up a small amount of flexibility over the trustee power noted above, it is probably the more conservative route.

If the spouse is the sole trustee or sole investment advisor under direction or delegation, could his or her indirect power to manipulate gains and losses on investments, and therefore basis, somehow deem such powers to be general over **all** the assets up to the remaining applicable exclusion amount? This would be quite a stretch, since the Uniform Prudent Investor Act and other common law fiduciary duties preclude any self-dealing or avoidance of diversification unless the document waives them.[62] There is a longstanding duty

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[61] The example did not specify whether the property TIC or LLC shares in trust was 100% or a mere fractional share. I assume here that taking 5/6 of the property is valued at 5/6 of the whole, which might be the case if the trust owned say 40%. If the trust owned 100% or 51% of the LLC, it may apply to a greater number of shares/membership interests.

[62] See, *Gifts by Fiduciaries by Tax Options and Elections*, November/December 2004 Probate and Property, by Jonathan Blattmachr, Stephanie Heilborn and Mitchell Gans, for a good discussion of gift tax effects of interested fiduciary decisions regarding Clayton QTIPs, investment choices, alternate valuation date, choice of where to

of impartiality imposed on trustees.[63] Thankfully, there is a clear regulation to protect from this: "The 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."[64]

Still, this may simply be one more reason for a conservative practitioner to use an independent trustee, co-trustee and/or investment trustee. Often there are important side benefits to this – there is much better asset protection when a current beneficiary is not sole trustee, plus this protects the surviving spouse from breach of fiduciary duty charges from remaindermen for bad investment decisions, or, simply protects the family from bad investment decisions in the first place.[65]

If such a design is still undesirable, it may be good reason to rely instead on granting the spouse a limited testamentary power of appointment eligible to trigger the Delaware Tax Trap, which could be over all assets equally. Any structuring to exploit a step up or avoid a step down would be done through the spouse's own Will or Trust exercising the *non-fiduciary* LPOA, rather than through the trust document or vagaries of investment return, and therefore immune to any such argument. However, the regulation cited above probably provides ample cover for surviving spouses as sole trustees. There are other various reasons that LPOAs and the Delaware Tax Trap should be considered discussed later in this article.

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deduct expenses and other dilemmas, concluding that independent fiduciaries are generally safer, but that investment choices by a beneficiary/trustee should not lead to GPOA inclusion.

[63] Restatement, 3d, Trusts, §79(2), §183, Uniform Trust Code §803, Bogert's Trusts and Trustees, Ch. 26 § 541

[64] Treas. Reg. §25.2514-1(b)(1)

[65] For a recent case "piercing the trust veil" by creditors where a son inherited funds from his deceased mother in a spendthrift trust, but he could appoint himself sole trustee, see *In re Heifner*, 2012 Bankr. LEXIS 3032 (Bankr. N.D. Ohio, 2012), also see separate trust piercing cases in author's separate asset protection CLE outlines. As a whole, practitioners are woefully unaware of the different standards bankruptcy courts use for piercing trusts. For a disastrous case of surviving spouse/trustee not only losing the inheritance through mismanagement, but also losing bypass trust benefits, see *Estate of Wendell Hester v. U.S.* (4th Cir. 2008).

Variations to Accommodate Separate *State* Estate and Inheritance Taxes

We do not want inclusion in the federal estate, even if it causes no estate tax, to also inadvertently increase *state* estate tax, unless there is a greater overall income tax benefit.[66] Consider the extremes: we may not want to grant a GPOA over stock bought at $95 rising to $100 at date of powerholder's death, because the $1 or so in potential capital gains tax savings does not justify inclusion if the state estate tax incurred is $12-16! Clients in those states may have a $1 of $2 million state estate tax exempt trust and up to $3.25 or $4.25 million state-QTIPed trust. Obviously the latter is first choice to cull any basis from by inclusion in the beneficiary's estate.[67]

Conversely, assets with a lot of gain may benefit from an increase despite any state estate tax. With the exception of Washington, most states that have estate tax also have a substantial state income tax, so that savings should be considered as well. The gold in the example above might be said to benefit from $40,000 of so of savings by increased basis ($100,000 gain time 31.8% federal, 8.2% net state income tax), as opposed to perhaps $24,000 or so in state estate tax loss ($200,000 inclusion times 12% rate). Again, this can be accomplished with a formula to ensure that increases to the estate are only made to the extent that the value of the step up exceeds the cost of the extra state estate tax.

Practitioners in states with a $1 million or less estate tax exemption may opt for simplicity of drafting/administration and simply forego the GPOA over any state-estate tax exempt trust property, since the savings may not be as great. However, surviving spouses may change residence or the state tax regime may change (as it has recently in Ohio, Indiana Minnesota and other states). Some states have larger exemptions of $2 million, $3.5 million or more that make it more compelling.

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[66] Ohio's former estate tax, eliminated this year, failed to catch the Delaware Tax Trap (R.C. §5731.11), but most states piggy back onto the federal estate.

[67] While most states with an estate tax use the same criteria as the federal estate tax and Form 706 as their base, this is necessarily state specific. Pennsylvania's inheritance tax, for example, does not tax a general power of appointment (or limited power of appointment triggering the Delaware Tax Trap) as the federal estate tax would. See http://www.picpa.org/Content/Files/Documents/Resources/Presentations%20and%20Brochures/6545-Inheritance%20Tax%20Brochure.pdf. This creates a great loophole for Pennsylvania residents (which should be discussed with anyone planning to otherwise leave assets directly to a Pennsylvania resident).

Practitioners may want to modify their formula with something similar to soak up available state estate tax exclusion, and then limit appointive assets also subject to state estate tax. For example, only "collectible assets with basis 70% or lower than fair market value at date of death, real estate with basis 60% or lower, or any other asset with a basis 50% or lower." The above percentages are approximations and clients and practitioners may deviate from these considerably, but the concept is to create some greater threshold for inclusion if state estate tax were to be paid. Some clients may prefer to forego a basis increase at second death altogether if a 12-19% state estate or inheritance tax were incurred, on the theory that any capital gains tax can theoretically remain unrealized until the beneficiary's death and receive an additional step up. Depreciable assets may be preferred as appointive assets due to the ability of additional basis to decrease current taxation.

Practitioners in states with an estate/inheritance tax should consider whether to modify any formula to account for out of state real estate or tangible personal property. Some states' tax regimes exempt such assets from tax altogether, in which case you would want any GPOA (or LPOA appointment triggering the DTT) to apply to those assets first without fear of causing additional state transfer tax.[68]

Other states apply a convoluted percentage to tax out of state real estate and tangible property (it smells unconstitutional, but it would probably be upheld). For example, a taxpayer has $3 million estate, $1 million is out of state real estate and the state has $2 million exemption. Rather than interpreting this as a $2 million net estate for state tax purposes, resulting in $0 tax, this may result in a $3 million estate, tentative tax of $150,000, reduced by 1/3 due to the percentage of estate that is out of state property, or $100,000. Would a client (or his beneficiaries) want to pay a *reduced* state estate tax to gain additional basis? Again, it would depend on the nature of the asset, likely use in the hands of the beneficiary and its appreciation, but it becomes a closer call if state tax is reduced.

[68] Although the situs state may have its own separate tax, this is unlikely to be an issue because most taxpayers who have real estate/tangible property out of state over a state's exemption amount (usually $1, $2 or $3.5 million), will have such assets in an LLC. However, some states such as Maine may attempt to tax that as well. See description of Pennsylvania tax in footnote above for example of state that does not tax out of state property.

Crafting GPOAs to Keep Fidelity to the Estate Plan and Preserve Asset Protection

This brings us to the second perceived drawback of such planning – the potential thwarting of an estate plan by the inclusion of a testamentary general power of appointment. Remember that the IRS has historically bent over backwards to construe a GPOA, because in the past it produced more revenue than a more restrictive interpretation.[69] Thankfully, we have a broad statute, regulations and many tax cases on which to rely, as well as favorable law in the asset protection context, so that GPOAs may pose little threat to the estate plan if properly constructed.

If the GPOA marital deduction is claimed, any GPOA must include the spouse or spouse's estate, not just creditors, and must be "exercisable by such spouse alone and in all events".[70] However, if no marital deduction was claimed, as we aim to do in an Optimal Basis Increase Trust, the following limitations may be included:

A GPOA may limit the scope of eligible beneficiaries so long as creditors of the powerholder are included. For example: "I grant my beneficiary the testamentary power to appoint to any of my descendants [or to any trust primarily therefore, which is usually an option for trusts not designed to qualify as a "see through accumulation trust" for retirement benefits].[71] My beneficiary also may appoint to creditors of his or her estate."[72]

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[69] Like horseshoes and hand grenades, you only have to be close. Someone does not have to know the extent of their power or even if they have one – if you give a mentally incompetent person or a minor a GPOA they don't even know or can't do anything about, it's still a GPOA for tax purposes. A surprising number of appellate cases address these issues, all finding GPOAs, even if someone is incompetent and even if a state court appointed guardian could not exercise the GPOA. *Fish v. United States*, 432 F.2d. 1278 (9th Cir 1970), *Estate of Alperstein v. Commissioner*, 613 F.2d 1213 (2nd Cir 1979), *Williams v. United States*, 634 F.2d. 894 (5th Cir. 1981), *Boeving v. United States*, 650 F.2d. 493 (8th Cir. 1981), *Doyle v. United States*, 358 F. Supp. 300 (E.D. Pa 1973), *Pennsylvania Bank & Trust Co. v. United States*, 451 F. Supp. 1296 (W.D. Pa. 1978), aff'd 597 F.2d 382 (3rd Cir. 1979), *Estate of Alperstein v. Commissioner*, 71 TC 351 (1978), aff'd 613 F.2d. 1213 (2nd Cir 1979), *Estate of Freeman v. Commissioner*, 67 T.C. 202 (1979). See also Rev. Ruls 75-350, 75-351.

[70] IRC §2056(b)(5), Treas. Reg. §20.2056(b)(5)(g) – though generally the whole purpose of the OBIT is to avoid forcing the marital, it's important to remember. This language is also why you can't simply let 5% of a GPOA lapse every year to let the marital trust escape estate tax altogether after 20 years or so.

[71] Accumulation trusts should exclude any IRA distributions from being appointed in further trust, since by default powers of appointment generally permit appointments in further trust, which may jeopardize a "see through" trust. Restatement, Third, Donative Transfers, ¶19.13 and ¶19.14, Uniform Power of Appointment Act (DRAFT), §305

[72] IRC §2041(b)(1) is in the disjunctive "or". See also *Estate of Edelman v. Commissioner*, 38 T.C. 972 (1962), *Jenkins v. U.S.*, 428 F.2d 538, 544 (5th Cir. 1970). As for spouse's POAs, see also Rev. Rul. 82-156 in accord.

Furthermore, a power is still a GPOA if it may only be exercised with the consent of a non-adverse party.[73] Who is "adverse"? Generally, it is someone with a present or future chance to obtain a personal benefit from the property – not all beneficiaries would always be adverse.[74] The jurisprudence is strongly in favor of finding parties to be non-adverse. In one Revenue Ruling, even a child who was a clear default remainder beneficiary of a trust was not considered adverse to her mother, who had a power to appoint to herself with permission of her child. Why? Because the child could have been divested via mom's special testamentary power of appointment, making her insufficiently adverse![75]

Surprisingly, even a trustee with fiduciary duties to beneficiaries who would clearly be adverse is not considered adverse itself.[76] For example, one might add to the above: "However, my beneficiary may only exercise said appointment with the consent of [name of non-adverse party, and/or] my trustee." If you name a trustee, then you would want to make sure the trustee is not a beneficiary, and perhaps insert provisions to enable appointment of a non-adverse party as trustee if, for instance, a beneficiary were the successor trustee (and adverse) and the beneficiary actually attempted to appoint to their creditors. If you name a non-adverse party, make sure to name alternates in the event the first is deceased or incapacitated. In theory, one could name multiple non-adverse parties necessary for unanimous consent, but pushing that envelope is hardly necessary.

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

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[73] IRC §2041(b)(1)(C)(ii), Treas. Reg. §20.2041-3(c)(2) As for spousal POAs, see also Rev. Rul. 82-156.
[74] Paraphrasing *Estate of Towle v. Commissioner*, 54 T.C. 368 (1970).
[75] Rev. Rul. 79-63 – a dubious ruling, but you can rely on it if you keep your facts close, unlike a PLR.
[76] To be adverse, the party must have a "substantial interest in the property subject to the power which is adverse to the exercise of the [GPOA]". An independent bank co-trustee, for example, is not sufficiently adverse. *Estate of Vissering v. Commissioner*, 96 T.C. 749 (1971), reversed on other grounds, *Estate of Jones v. Commissioner*, 56 T.C. 35 (1971), *Miller v. United States*, 387 F.2d 866 (1968). Treas. Reg. §20.2041-3(c)(2), Example 3. However, I prefer naming other non-adverse parties rather than trustees for simplicity in drafting and potentially asset protection differences (might a rogue court compel trustee acquiescence based on indirect fiduciary duty?)

power has been exercised."[77] This offers even more opportunity to make GPOAs more difficult to actually exercise, yet still come within the safe harbor of a treasury regulation.

If there is a qualified plan or IRA payable to the trust designed to be a see through trust (specifically, an "accumulation" trust, it would not be necessary for a "conduit" trust), one might consider a further restriction to prevent disqualification – "to creditors who are individual persons younger than my beneficiary" (a technique seemingly blessed by a recent PLR that permitted such a circumscribed GPOA to retain see through trust status).[78] Although the OBIT techniques herein to increase basis would not apply to IRAs or qualified plans,[79] you may have a GST non-exempt share over which a GPOA is desired. It would probably be preferred to use a conduit trust, but if for some reason that is undesirable, there may not be a lot to lose in circumscribing the GPOA in this manner as applied to such a trust.

Generally, I would not attempt to limit a GPOA in this manner for any non-standalone IRA accumulation trust – requiring appropriate non-adverse parties' consent should be more than adequate to prevent unwanted exercise. Although I could find no discussion in any restatement, case or otherwise, a reasonable interpretation might be that an attempted GPOA relying on the ability to appoint to creditors must include commonly found creditors to avoid being illusory. That said, it may still be prudent to limit the power to appoint to creditors to the amount of the *legally enforceable* debt and to reasonably equivalent value for contractual debt. Otherwise, a powerholder could in theory borrow $1 from anyone and/or promise to pay unlimited amounts in exchange for some peppercorn of valid consideration to enable an appointment of all the assets to whomever they wished.[80]

[77] Treas. Reg. §20.2041-3(b)

[78] See PLR 2012-03033, and discussion thereof in separate IRA "see through trust" checklist CLE materials developed by author. This PLR addressed the effect of a release creating such a limitation for "see through trust" purposes of identifying the oldest beneficiary applicable, but it did not discuss whether, after such a limitation, the power was still a GPOA and what the later tax effects might be. Pursuant to the plain language of the statute and Regs, it is still a GPOA, but at some point you have to wonder whether the IRS would argue such GPOAs are illusory – how many ***creditors*** out there are young individuals? While this trick is probably not good practice for drafting GPOAs, the counsel submitting this PLR were quite clever and successfully threaded the needle – although the IRS did not rule on that aspect in the PLR, the GST tax will probably still be avoided, because either the remaining power or the completion of the gift caused by the release at death will cause estate inclusion.

[79] IRC §1014(c), IRC §691

[80] Actually, the *Restatement, Third, Donative Transfers, §19.2* discusses the concept of a "fraud upon the power" as voiding any shenanigans to circumvent the intention of the creator of the power by attempting to appoint to impermissible beneficiaries, so extreme manipulations would probably not succeed anyway, but why tempt it?

In addition, any “consent” provision should ensure that there are backups and defaults to ensure that the consenting party has a bona fide ability to act.[81] This would entail naming alternates (my recommendation) and/or allowing a trustee, trust protector or local court to appoint a non-adverse consenting party (which might be a co-trustee). For example, if there is no way the "consenter" COULD consent, and the default in its absence were to deny the appointment, then the IRS may have an argument (albeit weak, considering the precedent) that there was no GPOA. What if a child who would be an adverse party is trustee or co-trustee and never gets around to appointing a non-adverse trustee? What if the non-adverse party is dead or incapacitated, renounces (or worse, disclaims) their power to consent, or is simply never informed of the existence of their consent power, or never returns the trustee’s phone calls, letters, emails (all very possible)? Those problems can be drafted around. For instance, the document can permit an agent/guardian to act for incapacitated "consenter", you can name alternates, and, of course, you should probably have the default be to ALLOW exercise rather than deny it.

For instance, a default might be to allow the decedent's GPOA to be exercised unless a written acknowledgment of the "consent" power is received from a "consenter", or the trustee has actual knowledge that the consenter has been informed, within so many months. Then you would need language to allow agent/guardian consent, and language to trigger or even appoint an alternate "consenter" under certain circumstances. You could have mere receipt of acknowledgment deny the effectiveness of the GPOA unless consent is timely granted, or draft it as a veto power. Then you have a "default" of sorts that makes it clear that the GPOA is never illusory. Careful drafting can ensure it is clear that the capability of exercise is always there.

Testamentary GPOAs may exist even if the powerholder has no access to corpus during the powerholder’s lifetime – indeed, the powerholder’s lifetime interest is irrelevant.[82]

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[81] It is unclear whether a “consenting party” would be as liberally found as a GPOA powerholder, logically it should follow the jurisprudence cited in footnote 56 above, but, like *Crummey* powers, why not be safe and ensure the power is acknowledged? See Rev. Rul. 81-7 for the IRS take on present interests– but the IRS consistently loses cases in this area even with shoddy trust administration, and it is a completely different statute.

[82] Technical Advice Memorandum 2009-07025

While a handful of states have creditor-friendly state law impacting testamentary GPOAs (e.g. California), the law is generally quite favorable as to whether and when a testamentary general power of appointment subjects the appointive assets to the donee powerholder's creditors, and even in bankruptcy the assets are not subject to creditors.[83] It may depend on whether the power is exercised or whether it is merely allowed to lapse. Creditor access should be less likely if there are additional consent and notice requirements as discussed above, but again this depends on state law and there are apparently no cases discussing asset protection differences of GPOAs with the various proscriptions described above. This is in stark contrast to the exposure of a *presently exercisable* general power, which will be discussed further below.

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[83] See *Restatement of Property, Second, Donative Transfers*, §13.2, §13.4 (state law), §13.6 (bankruptcy) – best to check those for citation to your individual state law. See TX Code §112.035(f)(2), Cal. Prob. Code §682(b): "Upon the death of the donee, to the extent that the donee's estate is inadequate to satisfy the claims of creditors of the estate and the expenses of administration of the estate, property subject to a general testamentary power of appointment … is subject to the claims and expenses to the same extent that it would be subject to the claims and expenses if the property had been owned by the donee." If your state law is unfavorable like CA, it may be preferable to use the Delaware Tax Trap technique, which uses *limited* powers of appointment only. For a recent bankruptcy case discussing why non-presently exercisable and non-general powers do not cause inclusion in the bankruptcy estate, see *Casey v. Schneider (In re Behan)*, 506 B.R. 8 (Bankr. D. Mass. 2014)

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

In our examples of John and Jane Doe above, we presumed that the Optimal Basis Increase Trust used a formula GPOA to cause estate inclusion and increased basis. However, there is also a technique to accomplish the same result with a *limited* power of appointment. This involves IRC §2041(a)(3), colloquially known as the Delaware Tax Trap ("DTT"):[84]

> "(3) Creation of another power in certain cases
> To the extent of any property with respect to which the decedent—
> (A) by will, or
> (B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent's gross estate under section 2035, 2036, or 2037,
> exercises a power of appointment created after October 21, 1942, **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**."

The application of this rule, in conjunction with various states' rules against perpetuities, is complex. While many states have enacted "savings clauses" into their statutes (or passed a Uniform Act) that has closed off the ability of an LPOA to trigger this in most instances, there is one method usually left out of these savings statutes, and that appears to be available in most states. I will refer the reader to more learned articles on the subject, and concentrate on the method of triggering §2041(a)(3) which is the most likely to be available in the vast majority of states.[85]

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[84] See also Treas. Reg. §20.2041-3(e). There is a gift tax analog, §2514(e), but triggering gift tax only increases basis to the extent of gift tax actually paid, so this paper will primarily discuss the estate tax variant.

[85] For your specific state, see Howard Zaritsky's ACTEC 50 State and D.C. Survey of Rule Against Perpetuities Law, specifically p 8-10: http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf. There is also good discussion in *Estate of Murphy v. Commissioner*, 71 T.C. 671 (1979) (analyzing an LPOA appointment to a trust that contained another LPOA and finding under Wisconsin rule against perpetuities law §2041(a)(3) was not triggered). See also *Using the Delaware Tax Trap to Avoid Generation Skipping Transfer Taxes*, Johnathan Blattmachr and Jeffrey Pennell, 68 Journal of Taxation 242 (1988), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954062. While the DTT was not considered or discussed for this type of planning, this is not the fault of two of the sharpest estate planning minds in the country, rather, the exclusion was only $600,000 at the time. See also *A Practical Look at Springing the Delaware Tax Trap to Avert Generation Skipping Transfer Tax*, James P. Spica, 41 RPTL Journal 167, Spring 2006; *The Delaware Tax Trap and the Rule Against Perpetuities*, Stephen Greer, Estate Planning Journal Feb 2001. *Revising the RAP*, Patricia Culler, Probate Law Journal of Ohio, March/April 2012.

Generally, if Jane in our example had a *limited* power of appointment which permitted appointment in further trust, and Jane appointed those assets to a separate trust which gives a beneficiary a *presently exercisable* general power of appointment (sometimes referred to as a "PEG power"), this would trigger §2041(a)(3), cause estate inclusion, and therefore an increased basis under IRC §1014, just as a standard GPOA would.[86]

Thus, Jane's Will (or trust or other document, if permitted by John's trust) would appoint any appreciated assets to such a "Delaware Tax Trapping" trust as discussed in the above sections, and other assets outright or to another ordinary trust. Treasury Regulations outline examples of specific, partial and targeted use of the Delaware Tax Trap ("DTT") as this article recommends:

> "Thus, if a decedent has a power to appoint by will $100,000 to a group of persons consisting of his children and grandchildren and exercises the power by making an outright appointment of $75,000 and by giving one appointee a power to appoint $25,000, no more than $25,000 will be includable in the decedent's gross estate under section 2041(a)(3)."[87]

In drafting mode, using the DTT is probably not an optimal strategy to employ for John's trust, because it will necessarily require Jane to draft a new Will/Trust invoking the LPOA and a new appointive trust with terms that one would ordinarily avoid. Giving a beneficiary a presently exercisable GPOA impairs asset protection much more than a testamentary power, and destroys any chance of spraying income or making tax-free gifts, nor does it allow avoidance of state or federal estate taxation or avoidance of a step down in basis at the child's death.[88]

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[86] See discussion in ACTEC survey and articles cited in the above footnote. All of those, plus other sources I consulted, conclude that this should trigger §2041(a)(3) under most states' RAP. This seems counterintuitive for a tax provision that is intended to attack delayed vesting and avoiding transfer tax, since a beneficiary holding a typical PEG power appears the *de facto* owner and would not be "GST-exempt" absent further planning, but that appears to be the conclusion of both accomplished authors and Treasury's own examples on this page.
Query whether a power of appointment may be crafted under state law so as to trigger a new vesting period and §2041(a)(3), yet not be a GPOA under §2514/§2041 or state creditor protection law, such as a power limited to ascertainable standards, or a power only exercisable with the consent of an adverse party. Without researching, my guess is that states would have closed what would have been quite a dangerous tax trap years ago.

[87] Treas. Reg. §20.2041-3(e)(2). There is a near identical gift tax reg at Treas. Reg. §25.2514-3(d)

[88] Contrast lifetime GPOAs in *Restatement of Property, Second, Donative Transfers*, §13.2 and §13.5 with the testamentary variations in §13.4 (state law), §13.6 (bankruptcy). Whether it's a testamentary or lifetime (presently exercisable) GPOA makes a difference in bankruptcy. See 11 U.S.C. § 541(b)(1): "**(b)** Property of the estate does

With all of the above negatives, using the DTT to harvest the basis coupon probably has more realistic application in the context of preexisting irrevocable trusts that already contain an LPOA, as discussed in Part VII, and should probably not be used in planning mode to accomplish optimal basis adjustments, especially since many practitioners and clients rely on disclaimer funding, which kills the LPOA necessary for a DTT (unless limited as discussed in Part IV). However, if the trust for children pays outright anyway, and no disclaimer funding is anticipated, this route may be the easiest, and most flexible, to take.

Practitioners might even craft a lapsing "Crummey" power into the appointive trust so that if the GPOA lapses, assets flow into a self-settled, incomplete gift domestic asset protection trust with situs in Ohio, Delaware or other permitted state. As with Crummey powers, a portion may "hang", or various non-PEG powers may be retained to avoid any completed gift by the lapse. My personal preferred route would be to avoid "baking in" the DAPT, but to instead strongly encourage such an appointment and to mandate that trust funds be used to pay attorney fees and/or trustee set up fees associated therewith. It may also be possible to use non-voting, restricted LLC/LP shares to effectively curb a spendthrift beneficiary, and use the 5% lapse protection to effectively "freeze" the estate as to PEG powerholder's appointive assets over time.[89]

Another counter-intuitive technique a powerholder may use to trigger the DTT, but still protect from an improvident or spendthrift beneficiary would be to only grant the beneficiary a lifetime income interest coupled with a "presently exercisable" GPOA over ***only***

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not include— **(1)** any power that the debtor may exercise solely for the benefit of an entity other than the debtor;" . Colorado appears to be an outlier and more protective of PEG powers than most states, see *Univ. Nat'l Bank v. Rhoadarmer*, 827 P.2d 561 (Colo. App. 1991). Also for spousal elective share: see Uniform Probate Code § 2-205(1)(A). Surprisingly, the Uniform Probate Code is protective of GPOAs as against non-spousal creditors. See UPC §6-102, especially comment 3 at www.uniformlaws.org. No cases reported in the 2nd or 3d Restatements discuss the impact, if any, of a non-adverse party's required consent on creditors' rights (in CA, probably no effect – Cal. Prob. Code §680). Some states may have extremely protective statutes for even general powers of appointment. See South Dakota CL §55-1-26: "Judicial foreclosure of beneficial interests, powers of appointment, and reserved powers prohibited--Creditors may not reach powers of appointment or remainder interests. Regardless of whether or not a trust contains a spendthrift provision: (1) No beneficial interest, power of appointment, or reserved power in a trust may be judicially foreclosed; (2) No creditor may reach a power of appointment or a remainder interest at the trust level. The creditor shall wait until the funds are distributed before the creditor may reach the funds; and (3) No power of appointment is a property interest."

[89] IRC §2514(e) – the so called "5 and 5" lapse protection.

the remainder interest. This is still deemed a "presently exercisable" GPOA.[90] In an earlier version of this article, I had initially opined that this technique would probably cause only partial inclusion based on actuarial value of the remainder. *I was wrong*, and it is clear that a step up in basis over the 100% of the appointed assets is available:

> "(2) For purposes of the application of section 2041(a)(3), the value of the property subject to the second power of appointment is considered to be its value unreduced by any precedent or subsequent interest which is not subject to the second power. Thus, if a decedent has a power to appoint by will $ 100,000 to a group of persons consisting of his children and grandchildren and exercises the power by making an outright appointment of $ 75,000 and by giving one appointee a power to appoint $ 25,000, no more than $ 25,000 will be includable in the decedent's gross estate under section 2041(a)(3). **If, however, the decedent appoints the income from the entire fund to a beneficiary for life with power in the beneficiary to appoint the remainder by will, the entire $ 100,000 will be includable in the decedent's gross estate under section 2041(a)(3)** if the exercise of the second power can validly postpone the vesting of any estate or interest in the property or can suspend the absolute ownership or power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power."[91]

Remember that you cannot use a non-adverse party consent if the goal is also to qualify the DTT/estate triggering for the marital deduction (this would be rare, however, since LPOAs usually *exclude* subsequent spouses as potential appointees, but it is possible – imagine the LPOA in the bypass or other inherited trust is broad enough to permit appointment to a spouse, in which case the powerholder could appoint to a Delaware Tax Trapping GPOA marital trust for the surviving spouse getting a full step up without causing estate tax – this is advantage of LPOA/DTT over formula GPOAs – see discussion below). Non-adverse party consent may also make the GPOA not "presently exercisable", required for triggering the DTT.

The formula GPOA would be more advantageous than using the PEG/DTT because of better estate/gift/GST sheltering, ability to spray income, and superior third party settled trust protection, but using the PEG/DTT techniques can offer substantial protections and advantages nonetheless. Ideally, states will amend their Rule Against Perpetuities statutes to

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[90] See *Restatement Third Property, Wills and Other Donative Transfers*, §17.4, comment a, illustration 1, and draft Uniform Power of Appointment Act, §102, comments re ¶14. It is not testamentary because the powerholder can make an irrevocable transfer of the remainder, effective immediately.

[91] Treas. Reg. §20.2041-3(e)(2), there is a nearly identical gift tax regulation at §25.2514-3(d)

permit LPOAs creating further LPOAs to trigger the DTT, obviating the need to use PEG powers.[92]

Is the DTT *safer* than a formula GPOA for capped estates? Addressing the *Kurz* case and other potential IRS arguments for attack on formula GPOAs

Some practitioners may prefer using the Delaware Tax Trap for another reason altogether. They may fear that the surviving spouse's control of his/her net estate value (either through spending, or by leaving assets to charity/spouse), may permit indirect control of the value of the appointive assets in the bypass trust subject to the formula GPOA provision and hence could trigger over-inclusion. Here is an example of the theoretical argument: John leaves Jane $4 million in a trust with a formula GPOA (optimal basis increase provision as discussed). She has $4 million of her own assets and $6.5 million applicable exclusion amount. At her death, John's trust caps Jane's GPOA at $2.5 million, based on her remaining applicable exclusion amount. Might the IRS argue, however, that Jane could have spent all her money, or left it to charity, thus de facto being able to control the disposition (i.e., GPOA) of all $4 million of John's trust despite the fact that Jane has no power to control or direct the excess $1.5 million? Formula funding/channeling clauses based on a surviving spouse's available GST amount have been used for decades in GST non-exempt trusts without such specious arguments.[93] However, there is some facile plausibility to the argument and a case that on the surface appears to help it, so let's distinguish the case, discuss why the "ballooning GPOA" argument has no merit, and how to avoid it anyway.

In the *Estate of Kurz*, husband died leaving his wife a marital trust with an unrestricted lifetime GPOA, and if that were exhausted, a lifetime 5% withdrawal power over the bypass trust. [94] The estate argued that the 5% power was not in the estate because of a condition precedent not being met. Treas. Reg §20.2041-3(b) provides that:

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[92] See http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf, ironically, even Delaware has foreclosed this use for GST exempt trusts, the very situations where it will now most often be useful. According to the survey, Kentucky and Wisconsin have the most useful (or, treacherous, if dealing with an inadvertent appointment and large estates) statutes, in that appointing to a trust that grants a *testamentary* GPOA can also trigger 2041(a)(3), which would at least improve upon the asset protection/control issues.

[93] See, e.g., Howard Zaritsky, Carol Harrington and Lloyd Plaine's treatise *Generation Skipping Transfer Tax*, various forms channeling distribution of "the largest amount, if any, of my wife's available GST exemption"

[94] *Estate of Kurz*, 101 T.C. 44 (1993), affirmed by 68 F.3d 1027 (7th Cir. 1995) – I suggest reading both opinions.

> "A power which by its terms is exercisable only upon the occurrence during the decedent's lifetime of an event or contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent's death. For example, if a decedent was given a general power of appointment exercisable only after he reached a certain age, only if he survived another person, or only if he died without descendants, the power would not be in existence on the date of the decedent's death if the condition precedent to its exercise had not occurred."

However, all the wife had to do was ask for funds for the marital trust and she was entitled to the 5% from the bypass. It would not surprise any tax practitioner that both the tax court and the appellate court concluded that the wife held a GPOA - she could effectively access the 5% of the bypass trust *at any time, for any reason, without affecting her estate, during her lifetime*.

The tax court's rationale was that the "contingency" 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 death. It looked to the examples in the regulation quoted above, and noted that those examples of contingencies were not easily or quickly controlled by the powerholder, "something that depends on the course of an entire life, rather than a single choice made in the administration of one's wealth."

In contrast to *Kurz*, a formula GPOA OBIT 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) – it is pursuant to other treasury regulations cited herein.[95] 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. Let's take apart the "ballooning GPOA" argument in two parts – the

[95] E.g., Treas. Reg. §20.2041-1(b)(3)**:** "***Powers over a portion of property.*** If a power of appointment exists as to part of an entire group of assets or only over a limited interest in property, section 2041 applies only to such part or interest" See also, Treas. Reg. §25.2518-3(d) example 20, quoted and discussed on page 20, footnotes 43, 44

purported control by lifetime giving/spending/debt incurrence, and the purported control by testamentary charitable/marital bequest.

If, as some would argue, the surviving spouse's ability to enlarge the formula testamentary GPOA by bankrupting themselves constitutes *control*, then arguably every beneficiary of an irrevocable trust with a means tested provision should be deemed to have a de facto general power of appointment. E.g., Jimmy, an irrevocable trust beneficiary, was used to a lifestyle spending $200,000/yr after tax. The trustee has paid him little if anything previously under "health, education, maintenance and support in the lifestyle in which he is accustomed, taking other resources available into account". Jimmy quits his job, spends all his money on expensive gene therapy, gambling, drugs or whatever. He's now arguably entitled to $200,000/yr from the trust, even though he could adopt a frugal lifestyle, get a job and/or subsist on 1/10 that. Under the *de facto control* argument, Jimmy would have a GPOA over the trust or at least over the present value of $200,000/yr if the trust is larger, but we know he doesn't, because Jimmy's ability to indirectly access/control the amount of appointive assets available under the trustee's fiduciary power of appointment is trumped by the more specific and clearer rules of IRC §2041/§2514 which clearly do not cause Jimmy to have a power of appointment in spite of his indirect control, even if Jimmy were trustee!

What of the ability of a powerholder to indirectly augment their GPOA via marital/charitable bequest? This certainly sounds like the more plausible line of attack. Again, let's start with an example: Sandra is a widow with $7 million AEA and $7 million estate who has a formula GPOA over a $4.5 million bypass trust, left to her by her late husband (assume the cap is based on net estate *after* marital/charitable deductions). If Sandra gives $2 million to charity, she would otherwise have $2 million of additional basis increasing "coupon" to use over the bypass trust, if she gives $4.5 million to charity, she would in theory have control over all of it. Ditto if she marries and leaves the equivalent to her new husband. Does her ability to control the amount of the GPOA mean it is all in her estate *even if she makes no charitable contribution*?

Not if we properly understand the goal and theory behind IRC §2041 and estate taxation of GPOAs, espoused by *Kurz* and other cases. Taxation of a *testamentary* GPOA must look to the value of what assets it permits the powerholder to transfer to the powerholder, powerholder's estate or creditors of either, at the time of death.[96] Even taken together, under any scenario above, Sandra's power to transfer to *that expanded class* of appointees is still limited to $7 million (AEA). Yes, she may have the *limited* power to control more by donating $4.5 million, but any additional control is at most an indirect LIMITED power, since any amounts above the AEA would necessarily have to go to charity and may not go to the powerholder, powerholder's estate or creditors of either. Under no circumstance or interpretation would she have the power to give $11.5 million to that class.

Despite the above analysis, many practitioners would prefer avoiding even the hint of a *Kurz* type argument against formula GPOA caps. Aside from the above arguments, might the IRS fashion some other argument about conditions subsequent (e.g. QTIP election) marring effectiveness of the GPOA? In short, a conservative practitioner should probably ignore any charitable/marital deduction otherwise available to the powerholder's estate in the GPOA capping formula until there is more positive precedent.[97] *In most cases and estate plans, this is unlikely to make much if any difference, so why take a chance*?

Some may also fear some kind of public policy argument similar to the gift tax formula valuation adjustment cases and rulings.[98] However, attorneys have been using valuation formulas in trusts for decades now, effecting bypass/marital, GST splits or otherwise, without any intimation that they are against public policy, not to mention that Treasury has many formula examples in its own regulations. Even aside from that, the recent gutting (or at least, mauling) of the public policy argument has been quite pro-taxpayer lately, even at the appellate level, with much more egregious facts, under *McCord, Petter, Christiansen, Hendrix, Wandry.*

Unlike a GPOA, the Delaware Tax Trap is only applicable *to the extent of EXERCISE* – there is no such thing as mere existence of an LPOA or a lapse of an LPOA causing inclusion under IRC §2041(a)(3) just because it *could have been* exercised to trigger §2041(a)(3).

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[96] This is essentially paraphrasing the 7th Circuit's *Kurz* opinion, at page 1029

[97] Thanks to California attorney Terence Nunan for pointing out this conservative drafting option. See his article *Basis Harvesting*, Probate and Property, Sept/Oct 2011, and sample language in appendix with both options

[98] See, *Commissioner v. Proctor*, 142 F2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944), and two subsequent revenue rulings wherein the IRS will not give effect to subsequent trust changes or subsequent formula valuation changes based on IRS reassessment of valuation. Rev. Rul. 66-144 and Rev. Rul. 86-41.

Therefore, using the Delaware Tax Trap OBIT technique is completely immune to the *Kurz or "powerholder control"* argument. Hence, many attorneys may prefer it, despite the advantages of formula GPOAs, for those estates that would likely be subject to capping.

Some may fear that using an LPOA to appoint to the same beneficiaries as would inherit by default might be illusory or disregarded. Thankfully, Treasury has prevented this result.[99]

[99] Treas. Reg. 20.2041-1(d): "However, regardless of local law, a power of appointment is considered as exercised for purposes of section 2041 even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment."

Comparing/Contrasting Formula GPOA v. LPOA/Delaware Tax Trap

Issues Favoring Use of Delaware Tax Trap/LPOAs over Formula Testamentary GPOAs

- **Spousal Use of Lifetime LPOAs/Gift Tax** - When someone exercises a lifetime LPOA, there is less chance of gift tax exclusion being used. Unless the appointment triggers the DTT, or unless income is mandated payable to the powerholder, there is no gift, whereas exercising a lifetime LPOA raises complicated issues if those assets are otherwise subject to a formula or capped testamentary GPOA – would IRC §2514 trigger a taxable gift even if the appointed assets were annuities, insurance, IRD or loss property not subject to the testamentary power?

- **Access by Powerholder's Estate's Creditors** – There is no asset protection issue if powerholder's estate is insolvent and a testamentary LPOA is exercised (or lapses) – creditors have no access. However, if the powerholder had a testamentary GPOA, depending on the state (e.g. CA allows creditor access), and potentially whether the GPOA is exercised, creditors of the testamentary GPOA powerholder's estate may have access.

- **Subsequent Amendments/Releases/Non-Qualified Disclaimers/Decanting** – Generally, LPOAs can be removed or limited without gift/estate tax issue, by decanting, reformation, release, trust protector or otherwise. While there are PLRs holding otherwise, any removal or limiting of a testamentary GPOA, even with a court approval, might have gift/estate tax effects under §2514.

- **Easier to go beyond formula wherever/whenever inclusion may be desirable** – Because the LPOA in the document would not be limited by formula, it can easily be used to cause inclusion beyond estate tax exclusion amount if desired for specific circumstance or change in tax code. As discussed in the section on state estate taxes, there may be cases where paying state estate tax is desirable because the overall income taxes saved by beneficiaries outweigh the state estate tax. In fact, if Congress were to change the tax code again, this could also be true of the federal estate tax. It already is somewhat - consider low basis collectibles taxed to a beneficiary in a high tax state with no estate tax.

- **Actions of the powerholder/trustee irrelevant.** As discussed herein, there is a weak argument that trustee's investment policy, powerholder spending or estate devise, pursuant to the *Kurz* case or otherwise, could be invoked to override the cap and cause more assets than desired to be subject to a formula testamentary GPOA. The LPOA/DTT technique is **completely immune** to these arguments, since §2041(a)(3) is triggered only upon and to the extent of exercise.

- **The *beneficiaries* have more post-mortem control over estate taxation/basis** – A recipient/appointee might disclaim a PEG power in a trust funded through the exercise of an LPOA that would otherwise trigger the Delaware tax trap and affect the upstream taxation/basis adjustment, but it is impossible for recipients to affect whether a GPOA is held at death or not. This could be important to flexibly allow increased inclusion for state estate tax purposes to yield federal, state and/or local income tax benefits by additional step up, or prevent over-inclusion. Disclaimers can be made partial or by formula.[100]

For example, Jane Doe has the limited power to appoint to the Jane Doe Delaware Tax Trapping Trust fbo Margaret, which grants Margaret a PEG power (presently exercisable general power of appointment). To the extent Jane appoints to this trust, and Margaret has a PEG power, it triggers IRC §2041(a)(3) – the Delaware Tax Trap. But, what if Margaret makes a qualified disclaimer of the GPOA, which relates back to remove her power ab initio? She can disclaim the GPOA and even remain trustee and beneficiary as long as her discretion is limited to an ascertainable standard.[101] ***This appears to allow Margaret, the beneficiary/appointee, to eliminate any estate inclusion due to the DTT, and hence any basis adjustment, by qualified disclaimer***. Non-qualified renunciations are disregarded.[102]

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[100] E.g. *Estate of Christiansen v. Comm*., 586 F.3d 1061(8th Cir. 2009)

[101] Treas. Reg. 25.2518-3(d)(6) – a qualified disclaimer is not a taxable release. Treas. Reg. 25.2518-3(a)(1)(iii): (iii) Powers of appointment. A power of appointment with respect to property is treated as a separate interest in such property and such power of appointment with respect to all or an undivided portion of such property may be disclaimed independently from any other interests separately created by the transferor in the property if the requirements of section 2518(b) are met. See example (21) of paragraph (d) of this section. Further, a disclaimer of a power of appointment with respect to property is a qualified disclaimer only if any right to direct the beneficial enjoyment of the property which is retained by the disclaimant is limited by an ascertainable standard. See example (9) of paragraph (d) of this section.

[102] Treas. Reg. 20.2041-1(e): "However, regardless of local law, a power of appointment is considered as exercised for purposes of section 2041 ***irrespective of whether *** the appointee renounces any right to take under the appointment." Presumably, Treasury did not mean "disclaims" instead of "renounces" here.

- **You can give your most trusted beneficiaries a de facto veto power, allowing more family control and more post-mortem flexibility**. For example, if I establish a trust for my wife, remainder to my daughters, I might want my daughters to have a veto power – to require their consent for any appointment by my wife – who knows what undue influence she might encounter without me! Remember, however, estate inclusion/GPOA status is not triggered under §2041(a)(2) and §2041(b) if I require adverse party consent. Perhaps I don't have a trustworthy person to be a "non-adverse party", or I fear creditors or others might browbeat or unduly influence the "non-adverse party" - and they would have absolutely no fiduciary duty whatsoever to my daughters (and they, no recourse). But §2041(a)(3) does not rely on a definition of a general power of appointment in §2041(b) – it pertains to the *exercise* of a *limited* power. If my daughter determines that for asset protection, dynastic, GST or other reasons she'd just as soon not allow the appointment, or would like to limit the appointment to the Delaware Tax Trapping Trust to certain assets, she can.

In fact, this even allows my daughter to pick and choose assets the assets to receive the new basis (the power should be clear that the consenting party can consent or not as to each particular asset). It gives an additional back up protection. For instance, if my daughter and her husband had creditor issues but they did not tell her mother (not uncommon) it would be ideal to forego the step up in basis afforded by appointing to a trust with a PEG power for the better creditor protection of an ongoing trust without one. While disclaimers of PEG powers may be possible, some states, and IRS liens, do not follow the relation back doctrine for disclaimers vis a vis creditor protection, so this method would be superior.[103]

- **An LPOA/DTT can be used by a QTIP as well.** This point is a bit non-sequitur, but I felt worth a mention here while discussing DTT nuances. Why would someone want to trigger §2041(a)(3) when QTIP assets are going to be included under §2044 anyway? **Aggregation**. As discussed in Part II, if a spouse has a home and an LLC both worth $1 million, each 50% owned outright, 50% in trust, the beneficiaries will get "discounted" step ups in basis, shaving off hundreds of thousands of dollars of valuable basis - inclusion under §2041 should lead to aggregation overriding the QTIP segregation of valuation.

[103] See various cases and statutes cited in footnote 23

Issues Favoring Use of Formula Testamentary GPOAs over Using LPOAs/DTT

- **Doesn't rely on obscure/arcane rule against perpetuities nuances.** Experts seem to agree that appointing to a trust that grants someone a presently exercisable GPOA triggers §2041(a)(3) because the GPOA powerholder can postpone vesting/suspend alienation without regard to the original RAP period. How confident are you that your state law does not have a savings clause or construction that prevents triggering §2041(a)(3) in such a case? How does this interpretation further Congressional intent of thwarting continued transfer tax avoidance if the GPOA causes gift/estate tax in the PEG powerholder's estate? While this technique appears to work (the regulations imply so as well), there is **no actual case** confirming this. The only reported case on this issue found that §2041(a)(3) was not triggered.
- **Less documentation/probate/paperwork, less chance of something falling through the cracks.** A formula GPOA doesn't even have to be exercised to get the intended benefit, but the LPOA/DTT technique requires an additional exercising document (usually by will), potentially a probate if by will. Plus, it needs a new separate "DTT-trapping" trust to appoint to (even if only one page).
- **Better ongoing asset protection for beneficiaries –** although the LPOA/DTT technique might be more prone to access by a powerholder's estate (discussed above), it is **much** more likely that one of the *children* have creditor issues than a bypass trust beneficiary. Even aside from outside creditors, granting a child a PEG power may jeopardize the assets (or even more likely, the growth on those assets), in a divorce. Query how a PEG power over only a remainder would be viewed.
- **No waste of GST exclusion, assets can excluded from beneficiaries' estates –** when a child or other beneficiary inherits in trust pursuant to a formula GPOA, GST will be allocated, and if properly drafted the subsequent trust escapes taxation in the beneficiaries' estate for federal and state estate tax. By contrast, this is near impossible to do if the beneficiary receives assets with an attendant PEG Power (w/ possible exception for annual 5/5 lapses).
- **Children or other beneficiaries can spray income –** If a beneficiary receives trust assets with a typical PEG Power, there is a forced grantor trust status under IRC §678(a), if the PEG power is limited to the remainder interest, then there would be a partial forced grantor

trust status as to principal. Whereas, if a beneficiary inherits in a standard trust, there can be income shifting and above the line charitable tax deduction opportunities availed of (discussed in Part VII).

- **Next generation use of Lifetime LPOAs/Gift Tax –** If a beneficiary receives trust assets with a PEG power, any subsequent use of lifetime POAs will trigger a gift tax and could be an assignment of income. By contrast, if a beneficiary receives assets without that burden, lifetime LPOAs and spray provisions may be used for better income tax planning.
- **No potential issue re triggering DTT if powerholder moves state –** If a surviving spouse moves states, will the new state of residency have the same ability to trigger the DTT? Perhaps, but maybe not. It raises a potential issue that GPOAs do not.
- **For intervivos SLATs, can revert to Settlor w/o impairing protection –** If the trust is question is a SLAT (aka inter-vivos bypass trust), and the donee spouse appoints back in trust to the original settlor/donor spouse, is the new trust considered "self-settled" subject to the original settlor's (now beneficiary's) creditors? If the spouse executed a GPOA, she would be considered the new grantor/settlor, but if the spouse merely executed an LPOA, this would "relate back" and therefore under most state laws the original settlor would still be considered the settlor and the trust would be accessible to the settlor-beneficiary's creditors. This favors the use of formula GPOAs for SLATs and JESTs (see part V).

NOTE: in the above section and comparison I have assumed use of only the most commonly discussed/accepted method of triggering §2041(a)(3), which involves the powerholder appointing to a new trust which grants a PEG power. If, in your state, there is a reliable way to trigger §2041(a)(3) without this generally undesirable feature (e.g. by appointing to a new trust that can postpone vesting/ownership and need not refer to the RAP applicable to the first trust and does NOT have a PEG power), then this would tip the scales to always using a limited power triggering §2041(a)(3) over a formula GPOA. State law has become extremely elitist in this regard, with savings clauses that hurt 99.5% of the population and help less than 1%. According to the ACTEC survey, Kentucky and Wisconsin will apparently allow §2041(a)(3) to be triggered by appointment to a new trust with a *testamentary* GPOA. Delaware, surprisingly, does not help either, because it bars the triggering if the trust is GST exempt (zero inclusion ratio), the very trusts that 99.8% of the population will now want to use it for! State bar committees/legislatures should consider amending their RAP statutes to “open the trap”, preferably by an affirmative and specifically referenced “opt-in”. Arizona has already done this, and Texas, Florida and Colorado bar committees have drafted proposed legislation for their bar/legislature to consider.[104] More will certainly follow. In the Appendix is a proposed variant of Delaware’s law, modified for use in Ohio.[105]

[104] ARS §14-2905(C). Thanks to attorneys Mickey Davis (TX), Justin Savioli (FL) and John Debruyn (CO) for sharing their respective state proposals modifying Tx Stat. Sec. 181.083, Fla Stat. 689.225, Co. Stat. § 15-11-1102.5. Other state bar committees should strongly consider reviewing these to adapt their own version.
[105] 25 Del. Code §504

IV. Busting Disclaimer Myths and the Conventional Wisdom on Disclaimers: *Why OBITs are Superior to Bypass Trusts for Disclaimer Based Planning*

After Congress' awkward dance with estate tax repeal over the last decade, many practitioners and clients have embraced disclaimer planning as the go-to tool for married couples with identical estate plans (e.g. long-time marriage, all children from current marriage). This usually involves setting up a bypass trust (and potentially marital trust, depending on design, assets and circumstance) that is ONLY funded if the surviving spouse makes a qualified disclaimer of funds that would otherwise be inherited outright.

There are several drawbacks to relying on disclaimer funding – inadvertent disqualification through acceptance or control, limited nine month window (no extensions unless the spouse is under age 21), uncertainty with certain jointly owned assets, and quite simply, the powerful inertia causing a widow/widower to "go with the flow" – especially when the flow is an outright bequest. For purposes of this Section, however, I will concentrate on another important drawback of disclaimer planning and how the OBIT largely eliminates it.

One of the axioms estate planners are continually taught is that surviving spouses must disclaim a power of appointment granted in a trust they are disclaiming into. Such a disclaimer removes a tremendous estate, asset protection and *income tax planning tool* from the surviving spouse's toolbox. **Moreover, this general rule is wrong**. The disclaimer regulations for spouses are much more nuanced than that:[106]

> "If the surviving spouse, however, retains the right to direct the beneficial enjoyment of a property in a transfer ***that is not subject to Federal estate and gift tax*** (whether as trustee or otherwise), such spouse will be treated as directing the beneficial enjoyment of the disclaimed property unless such power is limited by an ascertainable standard."

Thus, if the spouse is trustee and retains a discretionary spray power not limited by an ascertainable standard, or the right to transfer property by power of appointment that does not trigger estate/gift tax, then the disclaimer would not be qualified. However, this still leaves tremendous opportunities for various OBIT powers as discussed in Part III above.

[106] Treas. Reg. 25.2518-2(e)(2)

Thus, a GPOA can be retained by a spouse without tainting a qualified disclaimer, because GPOA transfers are of course subject to federal gift and estate tax under IRC §2514 or IRC §2041 respectively. As discussed in Part III, this would ideally be a formula testamentary GPOA with a cap. There is no real advantage to retaining a lifetime GPOA.

Moreover, an LPOA may also be retained, but only if can only be exercised so as to trigger the DE tax trap (IRC §2041(a)(3) and/or IRC §2514(e)), is limited by an ascertainable standard, or, unless the LPOA transfer would be in the surviving spouse's estate via IRC §2044 (QTIP).[107] Thus, while it is true that a disclaiming spouse must disclaim ordinary LPOAs in a bypass trust if funded via disclaimer, a disclaiming spouse may retain narrowly crafted ones.[108]

Thus, appropriately worded "OBIT" LPOAs and GPOAs are still compatible with disclaimer planning. Practitioners should consider creative post-mortem planning opportunities with these tactics as well (see further discussion in Part VII) – perhaps an LPOA can be partially released rather than completely disclaimed, for example. Most states should allow a partial release/nonqualified disclaimer of a testamentary LPOA unless the document forbids it.[109] See various sample clauses in the appendix.

Retention of LPOAs or GPOAs not only permit much better basis increase (and avoiding basis decrease) at the spouse's death, but they also open up more flexible ongoing income tax planning opportunities discussed in Part IX of this paper.

Moreover, even trusts that are not initially planned to be "disclaimer" trusts, may someday be forced to be, since clients inevitably fail to keep their trust fully funded. So these techniques should be kept in mind – disclaimer funding does not mean giving up all POA flexibility whatsoever – it just requires tailoring it.

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[107] There is authority that an LPOA may be retained by a surviving spouse to the extent the QTIP election is made: *Estate of Lassiter v. Commissioner*, T.C. Memo 2000-324, p70-74, ruled a disclaimer was qualified despite the surviving spouse retaining a testamentary LPOA, because the later transfer at the surviving spouse's death would be subject to federal estate tax due to the QTIP election, an exception under Treas. Reg. §25.2518-2(e)(2) quoted above. "We therefore conclude that retention of such a testamentary power does not cause the disclaimer of an inter vivos power to fail to satisfy the section 2518 requirement *when a QTIP deduction will be taken* for the trust to which the powers relate."

[108] Treas. Reg. §25.2518-2(e)(5) Ex. 5 illustrates why disclaiming spouses may not retain ordinary LPOAs in a bypass trust in order to be qualified, but Ex. 7 illustrates that disclaiming spouses may retain GPOAs (the "5 and 5" withdrawal power in the example is a lifetime GPOA, aka PEG power, "subject to Federal estate and gift tax")

[109] See, e.g., the draft Uniform Powers of Appointment Act, §401 and §404, but see Mich. Comp. Laws §556.118(2) for a counterexample.

V. Optimizing Basis Increase at *First* Death or Other Deaths via Upstream Planning

"[O]ne of the major purposes of the federal gift tax statute [is to protect] the estate tax and the income tax" *Dickman v. Commisioner*, 465 US 330, 338 (1984)

a. Community Property Nuances – Can Residents of Non-CP States Elect CP?

Married couples living in community property states automatically receive a new date of death basis for 100% of community property (which can, of course, mean a step *down* in basis for 100% of such property as well).[110] Some property might be separate even for those in community property states – such as property received by gift/bequest, or assets acquired prior to marriage. Increasing step up in basis at first death for such separate property (or avoiding double step downs for community property that has tanked in value) may be accomplished through postnuptial transmutation agreements.

For married couples in separate property states, jointly owned property is usually only entitled to 50% step up (or down).[111] Although, if a couple recently moved from a community property state, assets acquired as community property may be able to retain that status even in a separate property state. Those living in separate property states may be able to accomplish the same result as community property state residents through the use of an Alaska or Tennessee Community Property Trust, keeping "loss" and/or qualified plan or other problematic property out of the trust and transferring only appreciated gain property to the trust to elect into a community property regime.[112]

Example #1 (community property state): John and Jane are on their second marriage late in life and therefore have significant separate property. Residents of a community property state, John and Jane might enter into an agreement that $1 million each of their low basis property is community property ("CP"). Of course, if John's former separate property value skyrockets to $2 million, and Jane's stays the same at $1 million, and they are later divorced, this $3 million is 50/50 for divorce purposes. But many clients could live with this,

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[110] IRC §1014(b)(6)

[111] See IRC §2040(b), regarding tenancy by the entirety or joint with right of survivorship

[112] Alaska Statute § 34.77.100 et seq., Tenn. Code Ann. §§35-17-102, 103, 105. See, *The Tax Advantages of Using Joint Revocable Trusts and Alaska Community Property Trusts in Common Law Property States*, http://shaftellaw.com/article15.html, *Alaska Enacts an Optional Community Property System which Can be Elected by Both Residents and Nonresidents*, by David Shaftel, Stephen Greer, http://shaftellaw.com/article3.html Blattmachr, Zaritsky and Ascher, *Tax Planning With Consensual Community Property: Alaska's New Community Property Law*, 33 Real Property, Probate and Trust Journal 615 (1999).
Disclosure: the author's employer, KeyBank, has a subsidiary with trustee powers and operations in Alaska.

when considering that if one dies, all $3 million gets a new adjusted basis – a substantial windfall for the widow/widower and potentially others.

Example #2 (separate property state): Same as above, but John and Jane have never lived in a community property state. They gift those assets into an Alaska Community Property Trust, in which they **elect** to treat the property as community property. This should give the same result as above.

While there is a compelling argument that Alaska Community Property Trusts should work equally well, to date this technique has not been tested in the courts or subject to any IRS ruling. The only IRS pronouncement, a mere parenthetical in an IRS publication, takes no position.[113] Conflict of law principles should permit spouses to choose a state other than their domicile to govern their respective interests in property, and that state's laws should apply unless the domiciliary state has a strong interest or public policy in applying its own laws instead.[114] Using an Alaska trustee to hold legal title and provide various trustee services (even if they may be limited to investment or custodial services), should greatly strengthen the argument that it is appropriate to apply Alaska law.

Many couples, however, may not be interested in a solution that requires Alaska trustee services. Furthermore, this may not appeal to a spouse who has much more separate property than the other, because of the obvious divorce ramifications.

Additionally, there is at least one state in the union (probably the only state) that has a confusing prohibition on post-nuptial agreements (arguably, a "strong public policy" against them) – Ohio.[115] Would Ohio's statute prohibit its residents from entering into any agreement to deem property as community property? An Alaska CP Trust might be a good solution for recent Ohio transplants from CP states who may seek solutions to keep such property's character, because such transfers would not "alter their legal relations". But what about a couple that transfers what would be all marital property for divorce purposes in Ohio to

[113] IRS Publication #555 "Community Property", page 2
[114] See Restatement, Second, of Conflicts of Laws, §258, comment b, and §270 (regarding trusts). See also Uniform Probate Code 2-703
[115] Ohio R.C. §3103.06 "Contracts affecting marriage. A husband and wife cannot, by any contract with each other, alter their legal relations, except that they may agree to an immediate separation and make provisions for the support of either of them and their children during the separation."

community property? Have they "altered their legal relations" if the result upon divorce would likely be the same 50/50 split? How would the IRS see this? Couples would obviously intend to "alter their legal relations" for tax purposes. Would a simple declaratory judgment from an Ohio court that such an arrangement will not violate the statute help? Ohio's strange law in this area raises additional questions that have no clear answer.

a. Attaining Additional Basis at First Death – Integrating Optimal Basis Techniques

The so-called "joint GPOA" (fka poorer spouse funding technique) trust proposed by some to use in separate property states could be a disaster, because IRC §1014(e) may require a step down, but deny a step up.[116] Moreover, it may use up twice the gift/estate tax exclusion for no good reason. With these caveats, it should still be considered. This section will discuss ways to avoid these results and tweak for optimal basis increase results, and ensure the best chance for obtaining step ups in basis for both spouse's assets at first death, even in a non-community property state.

First, how does this structure typically work in the PLRs and articles discussing them? Let's say H has $2 million of property and W has $2 million.[117] Copying PLR 2006-04028, H puts his $2 million into his revocable living trust, W puts her $2 million into her revocable living trust.[118] Each trust grants the non-grantor spouse a general power of appointment (GPOA) up to their remaining applicable exclusion amount (some GPOAs in the PLRs are presently exercisable, some testamentary). Thus, if H dies, H can not only control disposition of his $2 million, but W's $2 million in trust as well (and vice versa). Mimicking the PLR, H amends his Will to appoint W's trust assets to his own trust at his death. Should H die, all $4 million goes into his trust.

[116] See PLRs 2001-01021, 2002-10051, 2004-03094, 2006-04028, TAM 9308002. Some practitioners question the holdings that transfers from the owner-spouse to the decedent-spouse at death qualify for the marital deduction under IRC §2523. However, other aspects of those rulings are non-controversial, and include the idea of capping a GPOA to an amount able to be soaked up by an appointee's available applicable exclusion amount – a key feature in this article that the IRS has expressed no problem with. Furthermore, smaller estates may not care about the marital deduction and "double use" of exclusion anyway.

[117] Thus, this is no longer really a "poorer spouse" technique, the "poorer spouse" problem has largely been eliminated by portability except for GST exploitation and common disaster scenarios – see Part I of this article

[118] Other PLRs use joint trusts, but my preference, and the preference of most attorneys in non-CP states, would be to use two separate trusts for better tracing and administration, but the same concepts apply to joint trusts

What everyone agrees on, including the IRS: at H's death, W's $2 million trust is included in H's estate because of the GPOA. W is deemed to have made a taxable gift by allowing H to appoint her $2 million to H's trust for her.

What everyone does not agree on: how the gift of the $2 million in W's trust transferred via H's GPOA is treated (does it qualify for the marital deduction? If not, is it partially a gift to oneself?) and whether an adjustment in basis is required. In addition to these two main issues, there are also potential issues with the step transaction doctrine, reciprocal trusts and state law creditor protection issues.

Marital deduction. All of the PLRs and TAM accept the premise that the $2 million gift qualifies for the marital deduction, even though the donee spouse would arguably be dead – the GPOA becomes effective, and the relinquishment of control by W to complete the gift, at death. Those rulings were quite favorable to taxpayers - arguably IRC §2523 would not allow the deduction.[119]

However, the marital deduction is now completely moot for many clients, whose combined estates may be under one spouse's applicable exclusion amount, especially when augmented by portability. In our example above, using 2013 values, denying the §2523 deduction would cause W to have $3.25 million basic exclusion amount instead of $5.25 million (due to $2 million gift not qualifying for the marital deduction). Her DSUE from H's estate would be either $5.25 million (if H's own $2million and GPOA appointment went to his wife or a marital deduction trust), or $1.25 million (if none of H's $4 million qualified for marital deduction), or in between for other dispositions, partial QTIP elections, etc. This still gives her between $4.5 million and $8.5 million AEA – either way, she is nowhere near having a federal estate tax issue by the loss of $2 million gift/estate tax exclusion (if it is that much, see below)! Even this effect can be mitigated with techniques discussed below.

The smart play by W may be (if the value merits) to at least try to claim the deduction on her Form 709 gift tax return and attach all relevant information – at least there is a decent

[119] Learned attorney opinions of the IRS's conclusions range from scathingly dismissive - "smoke and mirrors" to accepting - "common sense suggests that the IRS is correct on the marital deduction issue", from Clary Redd's article *Sharing Exemptions? Not So Fast*, Trusts and Estates, April 2008 and *It's Just a JEST, the Joint Exempt Step-Up Trust*, **LISI** Estate Planning Newsletter #2086 (April 3, 2013) by Alan Gassman, Thomas Ellwanger & Kacie Hohnadell, respectively. The issues are much more complex than you would think for a simple technique.

argument and several PLRs. After all, as discussed in Parts I and II of this article, treasury regulations accept the fiction of surviving spouses in qualifying for the marital estate tax deduction in simultaneous death scenarios, and there are cases that suggest the gift at the moment of death is to a surviving spouse.[120]

Furthermore, if IRC §2523 does not apply, who is the gift to if not to the spouse, and how much is taxable? This is never addressed in articles on this subject, but it may be quite important. If you cannot gift to a corpse (here, W gifting to her dead H), then the gift must be to H's estate or appointees, who are – you guessed it – W and children! If W makes a $2 million gift to a corporation or LLC in which she is 40% owner, the IRS looks through to the company owners as donees - it is not a gift of $2 million, it is a gift of 60% of $2 million - $1.2 million.[121] If a spouse or charity owns portions of the 60% it may be deductible for gift tax.[122] If you gift to a probate estate, the gift is really to the beneficiaries of that estate. If W inherits 100% of H's estate, then the gift is to herself, and not taxable. But, presumably, H's estate would pour into a trust in which W has a lifetime interest plus HEMS. If her share might be valued at 40%, shouldn't the result be similar to the corporation donee example? This is easy to value with a simple net income or unitrust, but if there are spray provisions, LPOAs, etc, keep in mind that "if the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift."[123]

More confusingly, I mentioned above that the true donees would logically be "H's estate OR appointees" – what if those are not the same? Arguably, W's gift would be to H's estate, not the appointees, because it was H's intervening decision to use his GPOA to appoint to the appointees. Thus, if W were H's heir at law and/or sole residuary beneficiary outright under his Will, there would be no taxable gift (because W would be gifting to herself), and yet, H may have appointed those assets elsewhere, to a trust that may or may not include W. This

[120] Treas. Reg. §20.2056(c)-2(e). See the *Bagley* and *Johnstone* cases cited and discussed in 422-429 of *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?* By Mitchell Gans, Johnathan Blattmachr and Austin Bramwell, 42 RPT Journal Fall 2007.
[121] Treas. Reg. §25.2511-1(h)(1)
[122] Of course, these deductions are based on what the donee receives, which, depending on the valuation of the business before and after, may not increase by the full $1.2 million – it may increase by less
[123] Treas. Reg. §25.2511-1(e)

leads us to the more important subtopic of how the step up in basis works, after which we will address ways to integrate the two statutes into planning and use savings clauses to prevent estates from the potential negative interpretations.

Into the Wind of IRC §1014(e) – Tacking Techniques to Increase Basis. Some of the PLRs referenced below, like PLR 2006-04028 and PLR 2004-03094, do not even address IRC § 1014(e). PLRs 2002-10051 and 2001-01021 and TAM 9308002 under similar facts did address this issue, and would deny the step up.[124] Or would they? The PLRs merely say that "Section 1014(e) will apply" – they do not say how and to what extent. And the TAM addressed an outright to spouse scenario rather than a typical trust bequest.

Here is §1014(e) in its entirety for better understanding:

"(e) Appreciated property acquired by decedent by gift within 1 year of death.
(1) In general. In the case of a decedent dying after December 31, 1981, **if--**
(A) appreciated property was acquired *by the decedent* by gift during the 1-year period ending on the date of the decedent's death, and
(B) such property is acquired *from the decedent* by (or passes from the decedent to) the donor of such property (or the spouse of such donor),
the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.
(2) Definitions. For purposes of paragraph (1)--
(A) Appreciated property. The term "appreciated property" means any property if the fair market value of such property on the day it was transferred to the decedent by gift exceeds its adjusted basis.
(B) Treatment of certain property sold by estate. In the case of any appreciated property described in subparagraph (A) of paragraph (1) sold by the estate of the decedent or by a trust of which the decedent was the grantor, **rules similar to the rules of paragraph (1) shall apply to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale**.

Did H "acquire the property by gift"? Arguably, H never received the property – for the same good reasons that argue *against* the marital gift tax deduction under IRC §2523 – he was dead at the time of the completed gift, so how can a corpse receive a gift? Quite simply, the property was never "acquired by the decedent by gift". Although Congress is not required to be consistent or even logical, the interpretation of these two sections should be consistent regarding the tax treatment of a transfer occurring at death. Either a court should deem the

[124] From PLR 2002-10051 - "In addition, section 1014(e) will apply to any Trust property includible in the deceased Donor's gross estate that is attributable to the surviving Donor's contribution to Trust and that is acquired by the surviving Donor, either directly or indirectly, pursuant to the deceased Donor's exercise, or failure to exercise, the general power of appointment over the Trust property." PLR 2001-01021 has near identical language.

recipient alive at the moment of transfer, in which case §2523 AND §1014(e) apply, or, you deem the recipient dead at the moment of transfer, in which case NEITHER §2523 NOR §1014(e) apply.

While some practitioners scathingly dismissed the former interpretation as a "gift to a corpse", it is just as logical to say that you cannot have a "gift to a corpse" for §1014(e). The IRS may ultimately have been quite savvy to have allowed the former interpretation, in that consistency would assure that §1014(e) also applies, and that interpretation may ultimately be more valuable to the federal fisc.

Let's assume H did "acquire" the \$2 million "by gift" prior to death (consistent with the IRS' §2523 rulings in the four PLRs/TAM) and address the second prong of §1014(e). Is it "acquired by the donor"? The simple answer in our case is "no", it is acquired by a trust in which the donor is a beneficiary. But trusts are simply legal fictions dividing legal and equitable title, obviously W is acquiring part of the equitable title. In addition, PLRs 2001-01021 and 2002-10051 cite the Congressional record – §1014(e) should apply to property "acquired by the donor…indirectly". One recent prominent tax court case ruling appears to indicate that a trust back to a donor/spouse within one year should not trigger IRC §1014(e), or at least that the IRS and tax court are ignoring the issue.[125]

IRC §1041(e)(2)(B) contemplates this possibility by specifically including someone who inherits outright through an estate or trust "to the extent the donor …is entitled to proceeds from such sale". But what to make of the first part of that sentence – does it only affect basis *when sold – what about for depreciation purposes*? What about tax-free exchanges, distributions? (an interpretation requiring later tracing makes little sense, and would cause bizarre "springing step downs in basis", but (e)(2)(B) arguably does this).

Most articles on this subject conclude that §1014(e) applies either 100% or 0% in our example of assets left in trust for W- but basic equitable law and trust valuation principles, coupled with the above language, argue that the step up for appreciated assets should be pro rated based on the valuation of the underlying equitable interests, based on the age of the

[125] *Estate of Kite v. Commissioner*, T.C. Memo 2013-43, fn 9 – wife funded trust for husband, who died one week later, assets came back to wife in trust and the tax court noted without discussion that "All of the underlying trust assets, including the OG&E stock transferred to Mr. Kite in 1995, received a step-up in basis under sec. 1014"

donor/beneficiary and the terms of the trust. In other words, perhaps (e)(1) applies once the estate and/or administrative trust is settled, regardless of later sales, based on ultimate equitable ownership. This is only my theory – there is no clear guidance here at all.

What if the surviving spouse were merely a discretionary beneficiary? Arguably in many states, as asset protection attorneys will tell you, a spouse with a mere discretionary interest has no property interest under state law, and the value of the spouse's interest should be $0. Many divorce courts and state marital dissolution laws will consider trust assets of a divorcing spouse only to the extent "vested" – the terms of the trust make a huge difference. However, the IRS is very likely to see this as some form of equitable ownership with value. In one recent private letter ruling where a beneficiary was a discretionary beneficiary of income and/or principal and had no need or history of receiving distributions, the IRS nevertheless said this interest had some value for gift tax purposes when it was proposed to distribute some principal to the remaindermen.[126]

And what does it mean for a spouse to be "entitled to the proceeds from such sale"? Even in a trust in which the spouse is entitled to all net accounting income, this doesn't extend to capital gains from a sale of property, which typically get added to principal. Under most trust designs, the spouse would not be *entitled* to any proceeds from the sale. Is actual receipt and tracing required for 1014(e) to apply? It's a terribly written statute.

But there are simple planning techniques that avoid the above nuances and ensure a full step up. First, of course, practitioners should make sure that only the surviving spouse's share of assets where the step up is warranted are subject to the GPOA, so at least any step *down* is avoided (see sample clause in appendix and discussion in Part III). Recall that IRC §1014(e), craftily, does not apply to "depreciated" property and cannot be applied to deny a *step down* in basis.

Furthermore, to make it clear that IRC §1014(e) should not apply to the appreciated assets, yet retain nearly the same access for the surviving spouse, consider making the

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[126] PLR 201122007

surviving spouse a permissible appointee of such trust under a child or other party's lifetime limited power of appointment, rather than a beneficiary.

Example #2: John and Jane, with children of the same marriage, each have $1 million of low basis property, and $1 million of cash equivalents, retirement plans, annuities, property with basis higher than FMV etc. John and Jane give each other a formula testamentary GPOA over each other's low basis property (this could be via joint trust, but my preference is still to use separate trusts). John dies. He leaves his $2 million to an OBIT trust for Jane (although he would likely leave retirement plans and annuities to her outright). Jane keeps her $1 million of cash, retirement plans, annuities, high basis "loss" property". John appoints Jane's $1 million low basis property over which he had a GPOA to a Power Trust with their children as beneficiaries in a pot trust, granting each of the children the lifetime limited power to appoint ("LLPOA") income and/or principal to Jane for whatever reason. This should result in a full step up in basis despite IRC §1014(e) because the funds are not coming back to Jane nor to a trust in which she is a beneficiary. Giving each child an LLPOA is to prevent the King Lear effect – as long as one of the children is a Cordelia rather than a Goneril or Regan, Jane should be fine. For an extensive discussion of the other asset protection benefits of "Power trusts" as opposed to DAPTs, email the author for a separate outline.

Using OBIT/JEST techniques at the first death for a married couple brings up additional planning techniques and concerns. First, despite the four PLRs discussed, to be conservative we should assume that §2523 will not apply (which enables us to circumscribe the GPOA for better asset and family protection as discussed in Part V above), and the technique will use TWICE the exemption amount (e.g. appointing $1 million will cost $1 million from **both** H's and W's AEA). For 90% of the population, this is still a winning deal, but we would be more selective with assets over which the GPOA applies for those with total estates over $5 million – favoring depreciable real estate that gives the surviving spouse a tax write-off, for instance, rather than artwork, home, etc that might not be sold until *after the surviving spouse's* death. Let's modify our example above with double the assets.

Example 3: John and Jane have $4.5 million each, comprised of $1.5 million in QP/IRA/annuities, $800,000 vacation home in JTWROS, $200,000 in art, autos and furnishings,

$500,000 cash equiv, $1 million stock portfolio, $500,000 rental property JTWROS with low basis. A GPOA over all the assets, as in the PLRs, could be disastrous here, if §2523 does not apply, but often couples won't need or use the step up at first death – the vacation home won't be sold until after the first death, and wouldn't be entitled to depreciation anyway, same with the art and cars. So, the GPOA in this case might be modified to apply to ***only*** the rental property and stock that has appreciated more than 25%. Let's say that is $1 million. If §2523 does not apply, and John dies, his DSUE is reduced by $1 million. For simplicity, assume Jane inherits John's other assets outright or in marital trust, so her remaining AEA is only $8.5 million due to the two $1 million transfers. However, she obtained the step up which could save her significant income taxes in retirement, and her remaining estate is only $8 million. The inefficient use of exemption may be a moot point, especially if Jane decides to make some charitable bequests in her estate. In fact, couples without children often have significant charitable intentions – *such techniques should be strongly considered for them, even with larger estates*, as noted above.

Flexible Provisions for Lifetime GPOA Trusts (aka JESTs) Using OBIT Techniques to Adapt to Either Interpretation of §2523/§1014(e)

As discussed above, when wife grants husband a lifetime or testamentary GPOA over her (or trust's) assets, at H's death, there is a taxable gift of the amounts subject to that GPOA – we just don't know whether it will ultimately be interpreted as a gift in which §2523 allows the marital deduction (or the extent of §1014(e) vis a vis trusts).

Wouldn't it be great to adapt our planning to either interpretation? For instance, a couple might prefer that **if** §2523 allows the marital deduction, such that §1014(e) would apply if the spouse is the beneficiary of the appointive trust, that the spouse is removed as beneficiary altogether, or made a purely discretionary beneficiary to better ensure the step up. The surviving spouse may remove him or herself as a current beneficiary through a qualified disclaimer, of course, but that assumes that you know the answer to that question within 9 months of the date of death (or 15 months, if a Clayton QTIP structure is used and a six month extension is granted to file the Form 706). Or does it?

Recall the Treasury guidance cited earlier in this article on formula disclaimers?[127] Disclaimers don't have to be over an entire estate or trust or IRA, they can be over any asset, and can reference a tax determination that may be years later in coming. Could the language be adapted as follows, substituting the appointive assets in question for the entire estate, and income tax reference for the estate tax reference: "The numerator of the fraction disclaimed is the smallest amount which will allow the appointive assets to pass with an adjustment to date of death basis under IRC §1014(a) and (b) and free of application of IRC §1014(e) and the denominator is the value of the appointive assets." If the IRS settles on a "gift to spouse at death" interpretation that permits a step up in basis even if the spouse is a beneficiary, the "smallest amount" disclaimed will be $0. If the IRS settles on a "gift to spouse at death" interpretation that would deny a step up under IRC §1014(e) if the spouse were a beneficiary, then the "smallest amount" under the above disclaimer will the entire amount, the spouse is removed as a beneficiary (but might remain a permissive appointee), and the trust assets can still achieve the step up in basis.

QTIP elections can be by formula referencing the federal estate tax situation of the decedent.[128] Protective elections are also specifically permitted.[129] But there is no reason it has to be a zeroed-out formula, nor any reason such a formula cannot include more than one factor. So, if the decedent-spouse appointed to a QTIPable Trust with Clayton provisions, what if the executor makes a QTIP election over such amount (numerator) necessary to zero out the estate tax, plus any such additional amounts comprising of lifetime gift tax exclusion used by the surviving spouse as a result of the death of the decedent spouse?

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[127] Treas. Reg. 25.2518-3(d), Example 20: "A bequeathed his residuary estate to B. B disclaims a fractional share of the residuary estate. Any disclaimed property will pass to A's surviving spouse, W. **The numerator of the fraction disclaimed is the smallest amount which will allow A's estate to pass free of Federal estate tax and the denominator is the value of the residuary estate.** B's disclaimer is a qualified disclaimer."

[128] Treas. Reg. §20.2056(b)-7(h): "Example 7. **** D's executor elects to deduct a fractional share of the residuary estate under section 2056(b)(7). The election specifies **that the numerator of the fraction is the amount of deduction necessary to reduce the Federal estate tax to zero (taking into account final estate tax values) and the denominator of the fraction is the final estate tax value of the residuary estate (taking into account any specific bequests or liabilities of the estate paid out of the residuary estate). The formula election is of a fractional share. The value of the share qualifies for the marital deduction even though the executor's determinations to claim administration expenses as estate or income tax deductions and the final estate tax values will affect the size of the fractional share.**"

[129] Treas. Reg. §20.2056(b)-7(c)

Alternatively: what if the testamentary GPOA in question were only granted to the decedent spouse using language similar to AB marital trusts? So, back to our example #3, Jane's trust might say "At my husband's death, if I survive my husband, my husband shall have a general testamentary power to appoint the Qualified Appointive Property. Qualified Appointive Property shall mean such property, or its proceeds, in the trust estate that, if given outright to my husband at his death, would qualify for the marital deduction for purposes of determining the gift tax payable because of the transfer made complete at the death of my husband."

Would such a precondition pass muster? Would the trend of the taxpayer victories in formula gifting cases such as *Wandry, Petter, Christiansen and Hendrix* help? Perhaps – but those concerned valuation rather than whether a gift qualifies for a deduction or not.

As complicated and uncertain as all of this is, we have not even addressed whether the IRS might make other arguments regarding §2523, such as whether the donee deceased spouse has a valid lifetime income interest that is not "terminable" at the time of death, or whether the infamous step transaction doctrine might apply. While there are plenty of cases where the IRS has argued "prearrangement" between spouses and lost, one of the most important "bad facts" for any step transaction case would be instantaneous successive transfers – an inevitable fact here.

In conclusion, until there is further guidance, wealthier couples with estates close to $10 million or above should simply avoid or narrowly tailor use of these joint GPOA techniques, *unless the bulk of their estate will go to charity at the second death anyway*, because of the potential for double use of exclusion as the price of the double step up in basis. They might consider an Alaska or Tennessee Community Property Trust instead. For couples with much lesser estates, there may be little to lose by attempting these techniques, especially if they are limited to the assets that would truly benefit the surviving spouse during his/her lifetime (e.g. near zero basis depreciable asset). Many of the ideas in the above pages should be improvements over the designs in the various PLRs. In my opinion, the *Upstream Crummey Optimal Basis Increase Trust*, discussed in the next section and related article, is far superior, because it largely avoids §2523, §1014(e) and step transaction issues.

c. “Naked” GPOAs: the Promise and the Limits of Upstream Basis Planning

One may be tempted in the understandable zeal to exploit GPOAs for basis planning to extend the concept even further. Can I give my 95 year old poor grandmother a GPOA or LPOA triggering the Delaware Tax Trap over $5 million of my trust assets? How about an entire religious order taking a vow of poverty, scant acquaintances or other poor and huddled masses yearning to be free? There are no reported cases or regulations under §2041 that address or prevent this, but practitioners should be skeptical nonetheless.

Ultimately, courts will have to sort out these limits. I believe an apt analogy is the court-sanctioned use of Crummey powers (which are essential presently exercisable general powers of appointment anyway) for those with some modicum of trust interest (so called *Cristofani* beneficiaries), as opposed to so called “naked Crummeys” (those with no other trust interest other than the PEG power). So, does grandma actually receive some income from the trust? Analogizing to *Cristofani*, the GPOA should be upheld. Ultimately, other GPOAs will likely be ignored as sham transactions.

Outright upstream gifts are unrealistic, impractical and undesirable on many counts – what if the upstream beneficiary does not have good automobile, umbrella or long-term care insurance or might disinherit you in favor of your brother or the local church! Obviously the best protection from those risks is to use a discretionary trust coupled with a narrowly crafted testamentary GPOA or alternatively, a narrowly crafted LPOA triggering the Delaware Tax Trap, rather than outright gifts. **We need a repurposed Upstream Crummey Trust**.

Example: John and Jane are in their late-60s, married, with 3 children, 5 grandchildren and 2 parents still living in their 90s. They have $8 million estate, John owns a $1 million depreciated property with only $50,000 basis. John gifts $140,000 (or less) to a standard Crummey trust for his wife and family, granting the children, grandchildren and parents Crummey powers – these will qualify for the annual exclusion. The trust purchases the real estate for $1 million, with $140,000 down and a remaining note at AFR or higher for $860,000. John and Jane’s parents have a narrowly crafted GPOA to soak up any remaining applicable exclusion amount they may have. When John or Jane’s parent dies, ***voila* !, new basis.**[130]

[130] See, *The Upstream Crummey Optimal Basis Increase Trust*, May 2014 issue of CCH Estate Planning Review

VI. Increased Asset Protection Opportunities Mimicking DAPTs Due to Larger Exclusion *(the "poor man's DAPT"?) – Using SLATs, Power Trusts, ILITs w/OBIT clauses*

In addition to all of the income tax opportunities offered by the increased gift tax exclusion, ATRA also offers up greater asset protection planning opportunities. Consider this variant of a DAPT for smaller estates: Husband sets up an irrevocable trust (aka SLAT – spousal lifetime access trust) for Wife (which may be defined as whomever he is married to at the time, since we do not need to qualify for the marital deduction as an intervivos QTIP or GPOA marital trust, aka "floating spouse"). Wife has a formula testamentary GPOA, circumscribed as discussed above. Wife and children have a *lifetime* limited power of appointment to appoint to Husband/Father. Merely being a permissive appointee of a limited power of appointment should not threaten asset protection, even if the donor of the power is a permissive appointee.[131] If wife dies first, and the GPOA is exercised successfully in favor of a trust for the husband, husband is now the beneficiary of the trust, but it is not "self-settled", since the wife is the settlor.[132]

Unlike intervivos QTIPs or exercises of limited powers of appointment that "relate back" to the original donor of the power, the settlor changes at Wife's death pursuant to a GPOA (though with a lapse of the GPOA, the issue is murkier and it may only change as to 95%).[133] This means that the trust is **not** self-settled if Husband later becomes beneficiary in a trust established by his Wife under the SLAT's GPOA. This eliminates the main concern that people have with "SLAT" planning without a DAPT – the lack of access by a surviving spouse.

For inter-vivos SLAT (bypass) trust planning, remember the one-year rule in IRC §1014(e) discussed in Section V of this paper. As discussed in the above section, this can avoided by structuring the appointive trust differently if the donee/beneficiary spouse dies

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[131] While this is generally the common law, Ohio clarified its common law with R.C. §5805.06(B)(3)(a) – for additional CLE material on asset protection aspects of powers of appointment, email author for separate CLE outline discussing/contrasting the many advantages of "Power Trusts" over DAPTs.

[132] See UTC §401, §103(15), Restatement of Trusts, 3d, §10(d), outlining that a POA can be used to establish a trust and the settlor is the person creating or contributing property to it. This is clear when a GPOA powerholder appoints to a new trust, but uncertain if a GPOA powerholder merely allows the power to lapse. Is the lapse equivalent to "contributing property" or not? As discussed herein, §2041 doesn't even require a competent powerholder with knowledge, but state law might have a higher bar for being considered a "settlor".

[133] UTC §505(b), for Ohioans, see newly amended Ohio R.C. §5805.06(B)(3)(b) – protection is 100% in Ohio – note that for GST purposes, the 5% lapse is disregarded and the spouse with the lapsing GPOA would be considered the transferor of 100% for GST purposes – generally an optimal result. Treas. Reg. 26.2601-1(b)(1)(v)

within one year of the trust funding, but these entirely avoid the 1014(e) debate if one year passes. Realize – this comes at a cost of double use of gift tax exclusion, unless a Crummey/Cristofani type structure is used, as discussed in the above section, but even with that caveat, most couples have plenty of Applicable Exclusion Amount to soak up double use of exclusion for their highly appreciated assets – remember, ¾ of a couple's assets are very often cash, short term bonds, IRAs, annuities, qualified plans and their home.

Of course, the power of appointment in the SLAT can be structured as a formula GPOA/LPOA as discussed in Section III of this paper, so as not to inadvertently cause any step **down** in basis, but this use may mean giving up some asset protection as to the LPOA appointive assets or forcing the use of a domestic asset protection trust statute such as the Ohio Legacy Trust Act. This is because, if W uses a testamentary **LPOA** to appoint back to a trust for H, it would **not** change the settlor for asset protection purposes (the "relation back" doctrine applies).[134]

In some states, you can accomplish the same *asset protection* result with an intervivos QTIP, so that less gift/estate tax exclusion is used, and it could come back to the donor-spouse.[135] In other states, an intervivos GPOA marital may be preferred to achieve the same asset protection result, but recall that the GPOA for a marital trust must be more open to use/abuse, and is therefore less protected from the spouse's undesired exercise and the donee spouse's estate's creditors. Furthermore, intervivos marital trusts cannot protect from 100% step downs in basis at the spouse's death.

Unlike DAPTs, which have to be done in certain states, use certain trustees, and have various uncertainties, requirements and drawbacks, SLATs with these kinds of provisions can be done in any state. For a comparison chart between "Power Trusts" and DAPTs, see author's separate outline.

Grantor trust status for such a trust after W's death is tricky. If H establishes a trust for W and she exercises a GPOA to appoint back to a trust for H, W is now the grantor for income

[134] Arizona may be an exception. See Ariz. Rev. Stat. 14-10505(E)(3)
[135] See footnote 34 for a list of state statutes and further explanation

tax purposes, overriding H as the grantor.[136] This overrides any provisions or conclusions that would otherwise deem H the grantor under IRC §671-679, making it a non-grantor trust.[137] However, if W merely allows her GPOA to lapse at her death, and the trust then continues for H, it is unclear, perhaps for state creditor protection law as well.[138] This may be another area where state law, estate tax and income tax law do not necessarily stride in lock step.

ILITs (also see section on the Upstream Crummey Optimal Basis Increase Trust)

ILITs should not be overlooked in considering optimizing basis clauses, and can benefit just as much as any bypass trust. This is not to achieve a step up or avoid step down in basis on the insurance policy – it's the investment proceeds after the insurance policy pays off.

Example: John establishes an ILIT for his wife and kids – he's young, it's a $2 million term policy. John's remaining estate is $1 million. Lo and behold he dies. His wife takes the $1 million in qualified plan and home outright, she has $10.68 million AEA. Jane has an estate well under this amount. Over time the ILIT investments triple in value – basis $2.5 million, FMV $6 million. With an OBIT clause, we really have the best of all worlds – if Jane's estate increases over time beyond her AEA (or if she loses her DSEU amount through remarriage), the ILIT can shelter funds from her estate, but if her estate remains under her AEA, **$3.5 million of basis is saved** – over a million dollars of income tax saved depending on the state and brackets of the beneficiaries. And, as discussed in Section III, this should be crafted so as to avoid step downs on any loss assets and apply to the most appreciated assets first in the event the amount must be capped. Needless to say, language should coordinate with the bypass trust to be read *in pari materia*.

DINGs (NINGs, OINGs and other INGs). These are generally designed to be in the settlor's estate at the settlor's death, but upon death can simply be appointed to A/B trusts that have "OBIT" features. See Part VIII(e) for more tax shifting ideas for these trusts.

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[136] Treas. Reg. §1.671-2(e)(6), Example 9 – thanks to attorney Gary Maddox for correcting a typo and suggesting clarifications to this discussion.

[137] Treas. Reg. §1.671-2(e)(5)

[138] Treasury could have simply added the words "lapse" or "release" of a GPOA in §1.671-2(e), as in other sections, but did not. Absent an *exercise* of a GPOA, it is unclear under what authority a lapse would override H as the grantor under IRC §671-679 (due to access to income, swap/substitution power, income for insurance or other administrative power). Therefore, H may still be considered the grantor of the trust for income tax purposes, since, contrary to the regulation, W did NOT exercise her GPOA.

VII. Use of Optimal Basis Increase Techniques by Pre-Existing Irrevocable Trusts

The concepts herein can also be applied to inter-vivos irrevocable trusts and trusts continuing for additional generations. Similar techniques can be incorporated in downstream dynastic trusts for better basis increases to grandchildren and beyond. This would involve GST considerations as well.

Most importantly, practitioners should not overlook the significant value in adapting many pre-existing irrevocable bypass trusts (including intervivos SLATs, or other irrevocable trusts) to fully use this $5.34 million (and increasing) basis increasing "coupon". This may be done by various ways – triggering the Delaware Tax Trap using an existing limited power of appointment that permits appointment to trusts, or changing the trust via decanting or court reformation to add a limited or general power of appointment. Generally, non-judicial settlement agreements (aka private settlement agreements) are probably not ideal, since it is unclear to what extent those can make the necessary changes.[139] Using LPOAs would also be preferred over GPOAs. The reasons for the latter two statements will become apparent later in this Section. Choice of these options will necessarily be trust and state law dependent.

The advantages may be significant. Imagine how many current irrevocable bypass trust surviving spouse beneficiaries have well under $5.34 million in their personal estate? (actually, a widow(er) might have quite a bit more AEA if their spouse died after 2010 and they elected DSUEA).

Example: John died in 2008, leaving his wife Jane $2 million in non-IRA assets in a typical bypass trust, which has now grown to $3.5 million. Although some of the assets have been sold, rebalanced, the trust assets now have a basis of $2.5 million. Jane's assets are $2.5 million. Why waste $2.75 million of her $5.34 million "coupon" she is permitted to use to increase basis step up for her family? Jane therefore amends her will/trust to exercise her limited power of appointment granted in John's trust, mirroring language discussed above: assets with basis greater than FMV or IRD go to a trust for her children (or simply continue in trust under the residuary), and assets with basis under FMV (for which Jane and her family

[139] Ohio R.C. §5801.10(C) "The agreement may not effect a termination of the trust before the date specified for the trust's termination in the terms of the trust, change the interests of the beneficiaries in the trust***"; UTC §111 is much more vague.

desire the step up) simply go to a similar trust for her children that contains a presently exercisable general power of appointment, triggering IRC §2041(a)(3) and getting the family up to an *additional $1 million of basis free of charge*. And, of course, this exercise can be limited to her available Applicable Exclusion Amount and applied first to the most appreciated assets first, capped to prevent any estate tax and/or account for any state estate tax, or even chosen to exploit the assets most likely to be sold by beneficiaries first, as discussed above.

Many beneficiaries do not have current asset protection issues, asset levels close to a taxable estate or any desire to spray or gift inherited assets. Thus, the vast majority of LPOA powerholders and their prospective appointees would probably prefer to save income tax with a higher basis than avoid the theoretical negatives of a presently exercisable GPOA. Unless there are current creditors on the horizon, beneficiaries can always avail themselves of self-settled asset protection trust legislation in Ohio, Delaware, Alaska or one of the other jurisdictions that permit this. If there are, beneficiaries can disclaim their GPOA. So, in practical terms, the main reason to forego any use of the Delaware Tax Trap is if a powerholder wants to preserve assets for grandchildren or other beneficiaries.

But let's say Jane *did not* have a limited power of appointment, or doesn't like the drawbacks of granting the beneficiaries a presently exercisable general power of appointment. Aren't we taught after *Bosch* and similar cases and PLRs that trying to reform a trust for the marital or charitable deduction post-mortem (or post gift) should not be recognized?[140] Isn't this a similar trend for IRA "see through trust" rulings?[141]

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[140] *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967) held that a state trial court decision as to an underlying issue of state law should not be controlling when applied to a federal statute, that the highest court of the state is the best authority on the underlying substantive rule of state law, and if there is no decision by the highest court of a state, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. It does not say to ignore state law, as some practitioners fear. For one of several cases denying the marital deduction for attempts at a post-mortem "fix" or relying on marital savings clauses, see *Estate of Rapp*, 130 F.3d 1211 (9th Cir. 1998)

[141] Although taxpayers can argue that September 30 of the year after death should be the important date to "fix" a see through trust by, and I would still argue this in clean up mode, the IRS could argue that, except for disclaimers that "relate back", the Code and Regulations require there to be a beneficiary named by the owner/employee pursuant to the terms of the plan and/or default under agreement to obtain status as a "designated beneficiary" at the time of death, and if the trust changes terms significantly after that, it is arguably not the same beneficiary post-reformation that it was at the time of death, hence no DB, even if effective for non-tax law. IRC §401(a)(9) and Treas. Reg. 1.401(a)(9)-4, A-1. See PLRs 2002-18039, 2005-22012, 2005-37044, 2006-08032, 2006-20026, 2007-03047 and 2007-04033 (allowing reformation to affect tax result at death for IRA/trust), and more recent trending PLRs 2007-42026, 2010-21038 (contra).

These cases and rulings can easily be distinguished. Most of them concerned taxpayers trying to change the legal effect of what the trust terms were at the death of the original transferor (i.e., does it qualify as a marital, charitable or see through trust at death). They do not concern what a transferee decedent owned or didn't own at the time of a transferee's death.

IRC § 2041 concerns what rights and powers a decedent has over property. If trust terms change so as to be legally binding, they absolutely change those property rights. We know of cases and rulings, not to mention every treatise recommendation on the subject, wherein a beneficiary who becomes their own trustee without ascertainable standards (or can remove and cause himself or related/subordinate party to be trustee) should have those assets included in their estate. A GPOA is no different. The IRS can certainly try to enact a double standard, but the vast body of 2041 jurisprudence is to the contrary.

In Rev. Rul. 73-142, a grantor/decedent established a trust for his wife and children, not subject to ascertainable standards, and mistakenly retained the power to remove and become the trustee.[142] Years prior to his death, he went to court to successfully construe the trust to mean that he could not be appointed trustee (nowadays, we would also preclude removal and replacement with any related/subordinate party).[143] The IRS ruled that this court order had tax effect to negate the IRC §2036/2038 issue *despite the state court decree being contrary to the decisions in the state's highest court*. While this is not an IRC §2041 case, this Rev. Rul. bodes well for such proactive planning to add a limited GPOA for better tax results.

One PLR following Rev. Rul. 73-142 noted a key difference with *Bosch*: "Unlike the situation in *Bosch*, the decree in the ruling [73-142] was handed down before the time of event giving rise to the tax (that is, the date of the grantor's death)."[144] In that PLR, a state court order construing a tax apportionment clause to apply to the GST non-exempt marital share rather than equitably to both GST exempt and GST non-exempt shares was given effect. This was good proactive planning by counsel prior to the taxing event to keep more funds in a GST sheltered trust.

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[142] Rev. Rul. 73-142
[143] Treas. Reg. §20.2041-1(b)(1), Rev. Rul. 95-58
[144] PLR 2005-43037

Like the above rulings, any such modifications to ensure an Optimal Basis Increase would similarly affect a surviving spouse's rights *before* the time of his or her death, and with current trust law trends, such reformations would unlikely even be contrary to the state's highest court. Obviously, if beneficiaries try to fashion such a solution *after* both parents' deaths, this would be unavailing under *Bosch* and many other decisions. However, there is strong precedent that private settlement agreements, court actions pursuant to statute, decanting, trust protector or other methods to add a formula GPOA *prior* to the time of the event giving rise to the tax (the surviving spouse's death), should (and must) be given effect.

The reverse, removing a GPOA, is a more difficult issue, so any reformation should strongly consider the irrevocable nature of it. Generally, releasing a general power of appointment would trigger gift tax, and could trigger taxation of any IRD.[145] However, in one recent PLR, the IRS allowed a post-mortem court reformation to essentially remove a GPOA without adverse tax effect.[146] I would not count on this result for every post-mortem reformation removing a GPOA, but the PLR is instructive as to how the IRS applies the Supreme Court's holding in *Bosch*.

Any added powers of appointment can limit appointees to certain trusts. In our example above, if Jane had not been granted a limited power of appointment, the trustee might decant to a near identical trust which grants Jane the limited testamentary power to appoint certain assets to the Jane Doe Irrevocable Delaware Tax Trapping Trust, a trust established with terms nearly identical to her husband John's trust for the children, only granting the children a PEG power circumscribed using techniques discussed above. Indeed, this would be a more prudent exercise of the trustee's decanting power (or court's power to amend), since it would do less harm to the original settlor's intentions than adding a broad LPOA or GPOA (indeed, many trusts pay outright to children at some point anyway).[147]

While adding a limited lifetime or testamentary LPOA or formula GPOA, consider changing any "all net income" requirement to a more flexible standard that would allow spraying and/or accumulating income, and address capital gains, for better income tax

[145] IRC §2514
[146] PLR 2011-32017, see also PLR 2010-06005 approving reform of a GPOA to an LPOA w/o adverse tax effect
[147] For a great summary of the more than 20 various decanting statutes and their characteristics, see http://www.sidley.com/state-decanting-statutes/

planning (see Part VIII). In a recent PLR, the IRS ruled that such a modification that removed the "all net income" requirement was not a taxable gift, did not trigger gain, nor did it affect the GST zero inclusion ratio.[148] I believe the giving up of net income was not considered a taxable gift in the PLR because any accumulated income, pursuant to the trust amendment, was payable to and would be included in the beneficiary's estate. While this somewhat curtailed the GST advantage of removing the "all net income" requirement, it may have allowed high bracket beneficiaries to manipulate state income tax and increase asset protection.

With all the above arguments that §2041 should still apply equally to amended/reformed trusts, that is not to say that amendments may not have other effects. *Beneficiary procurement or even acquiescence to trust amendments may have detrimental tax and asset protection effects*. This statement probably surprises many attorneys, but I believe this is the most under-discussed areas of estate and asset protection planning in light of the tsunami of trust settlement agreements, amendments and reformations increasingly being used by practitioners pursuant to the Uniform Trust Code or other law.[149]

The *Sexton* case is instructive here.[150] *Sexton* involved an irrevocable trust established by a father for his seven children. The trust was due to terminate twenty years after the father's death, but could be amended by a majority of the trustees with consent of 2/3 of the beneficiaries. The beneficiaries consented to extend the trust past the original termination date. One beneficiary, Bertha, died after the original termination date but before the amended termination date. The IRS argued that the amendment was ineffective, but if not ineffective, still constituted a transfer subject to IRC §2036. The district court held, and 7th Circuit confirmed, that the amendment was effective pursuant to the trust and state law, but that *her complicity in this amendment* made her a de facto transferor for §2036 purposes. Since she had a right to funds at the original termination date, her acquiescence was a relinquishment of that right, which may be considered a transfer of property for estate/gift tax purposes. Importantly, the court noted had the beneficiary not consented,

[148] PLR 2013-20004, modifications complying with GST grandfathering regs were OK for *allocated* GSTexempt
[149] This is not to blame the Uniform Trust Code – many such options were probably available under common law before anyway, or in non-UTC states, but the UTC undoubtedly creates clarification, interest and awareness.
[150] *Sexton v. U.S.*, 300 F.2d 490 (7th Cir. 1962), cert denied 371 U.S. 820 (1962)

their argument that the amendment was not a relinquishment/transfer and therefore had no tax effect “might be persuasive” – but the beneficiary’s active consent killed her estate’s case, even though the amendment could have been accomplished without her consent. Another way to look at this case (not discussed in the opinion) is to see each beneficiary as exercising a GPOA (although other parties’ consent was required, they may have been *non-adverse* parties).

There was a district court case that held to the contrary on similar facts (though the issue was whether the extending amendment created a grantor trust rather than an estate/gift tax case).[151] The *Brooks* court found that exercising such powers (analogizing to limited powers of appointment) granted by the trust were **not** transfers of property. This district court case reasoning was rejected by the 7th Circuit in *Sexton*, but it also lays out the contrary argument that might be cited in “clean up mode”.

Another recent PLR highlights this: a mother was the current beneficiary (and co-trustee) of a trust and entitled to income and principal only at the trustee’s discretion for HEMS. She did not need nor want any discretionary distributions, had never taken any, and never expected to. Her children were remaindermen. Mother, children and trustees petitioned local court for an early distribution to the children, which would be allowed with consent, as long as it did not frustrate the settlor’s material purpose of the trust. The IRS held favorably on GST and income tax results, but held that, although the gift may be “nominal”, there is still a taxable gift by the mother for giving up her rights, however speculative in value.[152] The IRS offered no guidance as to how to value such a discretionary interest.

The lesson: procurement or even active acquiescence to creating a GPOA or even LPOA that could divest a beneficiary of a property right could be a transfer and taxable gift. E.g., mom is lifetime beneficiary of bypass trust, remainder to son. Mom and son agree, pursuant to non-judicial settlement, the trust or other state law, to give mom a GPOA. As stated in discussions of authority cited above, the IRS would probably have to honor this change in property rights at mom’s death if pursuant to state law. However, could son be said to have made an incomplete gift by converting his vested remainder interest into a vested remainder

[151] *Brooks v. Welch*, 29 F.Supp. 819 (D. Mass. 1938)
[152] PLR 201122007

interest subject to divestment? Could this trigger §1014(e) if done within one year of mom's death? If the property comes back to son, the "gift" would be to himself (but potentially creating a self-settled trust if appointed to him in trust), but if mom appoints to her son's children, would this make the son's tentative de facto gift of his remainder interest by consenting to the GPOA complete? This is mere speculation, and probably makes more than a few readers' heads spin. Here's the nutshell – it is safer to avoid this morass of issues with amending actions initiated by an independent trustee or trust protector only.[153]

It is only a matter of time before such arguments are used by creditors and bankruptcy trustees to attack any trusts amended in such manner as *self-settled trusts*. There are cases that bust such amended trusts when there is no clear amendment power in the trust or state law, but I would caution that such cases might be extended even to cases in which a debtor/beneficiary takes other actions to extend a trust.[154]

Could any amendments/modifications affect GST exemption? Not under most circumstances, but this is yet one more issue to examine when modifying irrevocable trusts.

> OTHER CHANGES.
> (1) A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.[155]

But as we've said before, fewer people are wealthy enough to care about the gift/GST tax much anymore, but there could also be arguments that amendments/reformations not done by the trustee via decanting or court petition or trust protector might not be effective. You cannot create a GPOA for yourself, nor can you create a GPOA if it is exercisable in

[153] See *Gifts by Fiduciaries by Tax Options and Elections*, cited and discussed on page 24, footnote 56.
[154] *Hawley v. Simpson (In re Hawley)*, 2004 Bankr. LEXIS 173 – finding that an extension of trust by beneficiaries created a self-settled trust, negating 11 USC §541(c)(2)'s ordinary protection/exclusion of third party spendthrift trusts, making it accessible to the beneficiary's bankruptcy estate. For more on busting third party trusts, how such actions might trigger fraudulent transfers and asset protection, see author's separate asset protection CLE outlines.
[155] Treas. Reg. §26.2601-1(b)(4)(i)(D):

conjunction with the donor of the power.[156] Well, who is the donor of the power in such an instance? Is it still the original settlor, as it would be with a decanting or trust protector power that is essentially exercising a limited fiduciary power of appointment? Perhaps, if the reformation is retroactive. Or, might the IRS claim that a spouse and child, for example, are the donors of the power in such instance? You would be in a better position with a court order stating that such an amendment is merely construing or reforming the trust to comport with the settlor's original intent by creating the LPOA/GPOA, so that it is more analogous to a decanting/amendment pursuant to the original trust terms. However, there is no clear guidance here.

Decanting with more common "HEMS standard" trusts *without* absolute discretion

There is an understandable misconception that decanting can only be accomplished with trusts having absolute discretion. However, many states have a dual track mode of decanting, one level of decanting that is applicable to wide discretion, one that is not. Ohio is illustrative: Ohio R.C. §5808.18 lays out two levels of decanting in paragraphs A (absolute discretion) and paragraph B (less than absolute discretion). The former is well known, similar to many other states and even is meant to codify Ohio common law.

The latter is a more difficult case, but such trusts are *much more common*. Why? Because many couples wanted to name their spouse as both beneficiary and trustee or co-trustee, so there is commonly a HEMS standard in Bypass Trusts.

Paragraph B of Ohio's decanting statute still permits "distributing all or any part of the principal subject to the power, and all or any part of any income that is not otherwise currently required to be distributed, to the trustee of a second trust.", but there is the additional requirement that "The exercise of a trustee's power under this division is valid only if the governing instrument for the second trust **does not materially change** the interests of the beneficiaries of the first trust."

This of course begs the question whether the narrowly crafted changes anticipated by this paper would *materially* change the interests of the beneficiaries of the original trust. How

[156] IRC §2041(b)

do you define *material*? If time permits you could decant and get the local probate court to approve it.

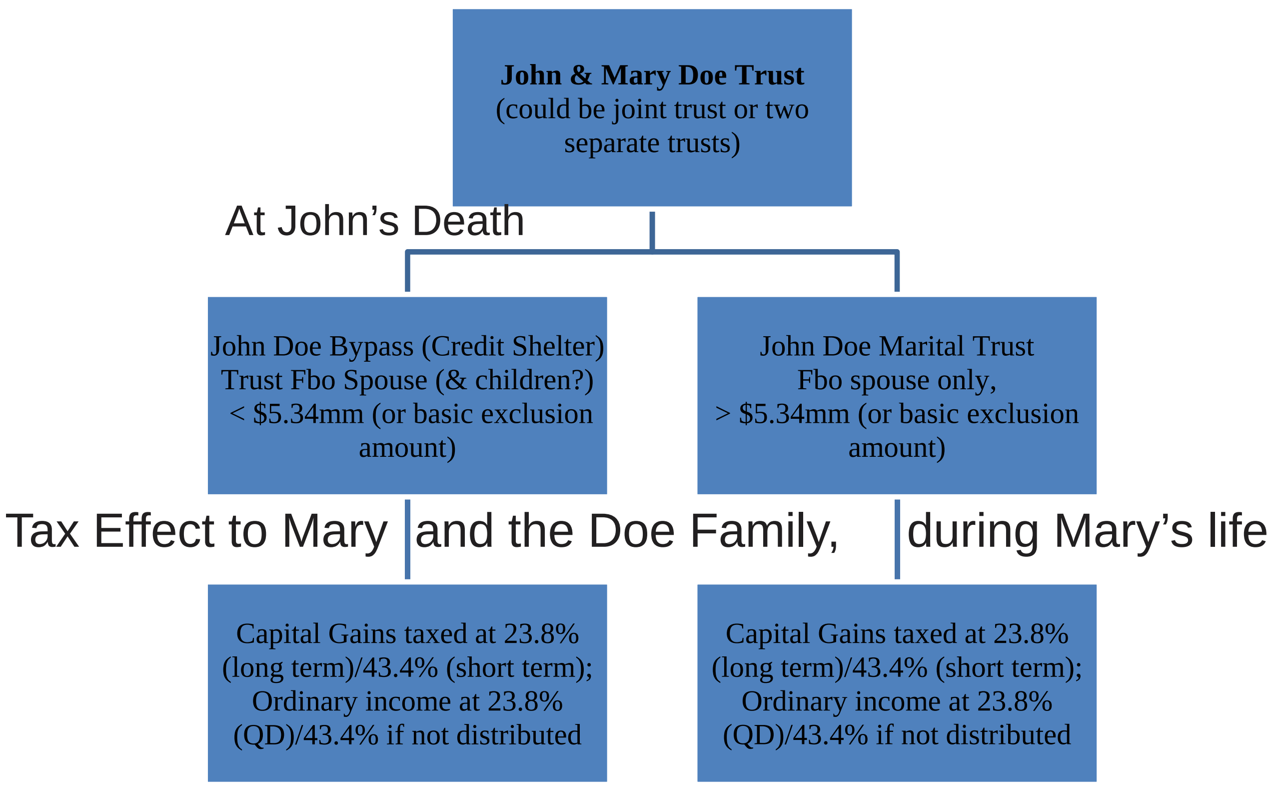
Of course, if you go to probate court, most states provide much clearer avenues for the trustee to accomplish a court reformation to achieve the exact same result, without the uncertainty that a "non-absolute discretion" decanting entails, so any court petition might ask for alternative remedies: approve the decanting, but if you can't approve the decanting, reform the trust .[157] The drawbacks to court petitions vary state to state, but are essentially the same as for any court process – is there much cost/delay? Will there be difficulty getting all the necessary beneficiaries served and possibly guardians appointed for minor children or incompetent beneficiaries? Might someone object at a hearing? Decanting avoids many of these issues, if it's clear, but a court order would lead to a much more certain result when there is not absolute discretion to decant. Perhaps there is a state decanting statute that would clearly apply in such situations, but I have not examined the 22 or so statutes.

[157] Uniform Trust Code §§411-418. E.g. Ohio R.C. §5804.16 **Modification to achieve settlor's tax objectives** "To achieve the settlor's tax objectives, the court may modify the terms of a trust in a manner that is not contrary to the settlor's probable intention. The court may provide that the modification has retroactive effect."

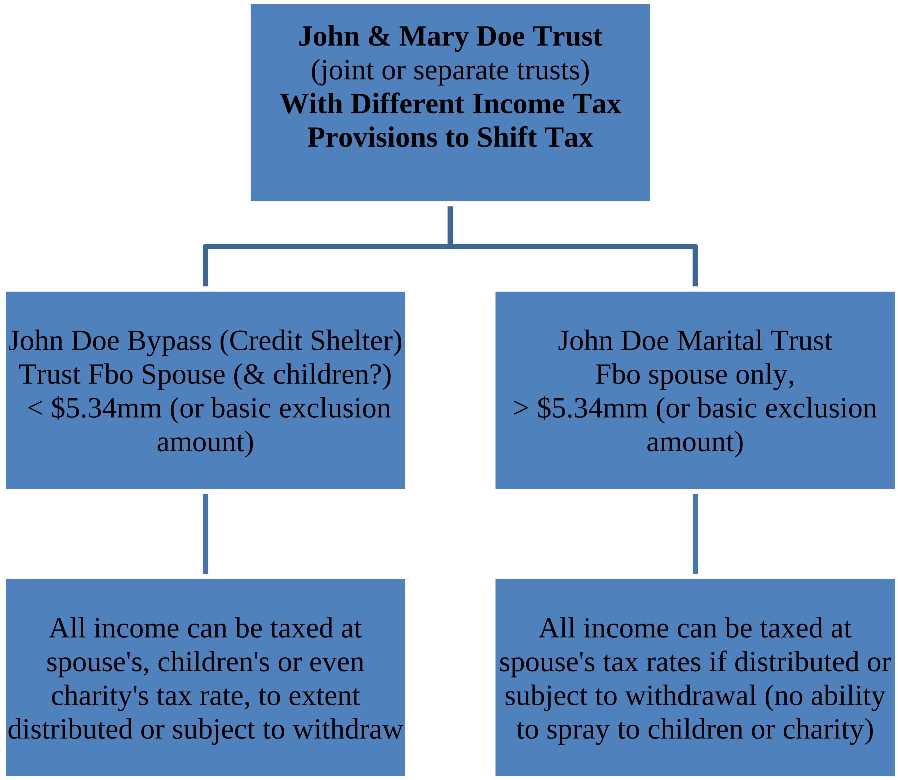
VIII. The Income Tax Efficiency Trust – *Ongoing* Trust Income Tax Planning Techniques

As mentioned above in Part I, there is another income tax issue after ATRA that may now dissuade the average couple from using ongoing trusts for planning. With the new tax regime, unless we plan, administer and invest carefully, the overall income tax to the surviving spouse and family will be higher every year, sometimes by a considerable amount.

Creative use of IRC §643, §678(a) and/or §642(c) provisions can ensure that capital gains are not trapped in trust at the highest rates, may get better tax treatment for special assets, and may even be sprayed to beneficiaries or charities in much lower (or even 0%) brackets. The first flowchart below outlines the ongoing tax effect of the traditional AB trust structure and the second flowchart envisions more efficient variations that will be discussed.



The above refers to trust tax rates on income exceeding $12,150 in 2014 (this number is adjusted for inflation). Certain income such as qualified plan or IRA distributions may be subject to a lower top rate because it is exempt from the 3.8% Medicare surtax. Higher long-term capital gains rates on depreciation recapture and collectibles are also ignored. "QD" refers to qualified dividend rate. The trapping of taxable income at trust rates might be exacerbated further depending on state income taxation of trusts as well.



First, let's pause for a refresher on how the new tax regime, including the Medicare surtax, affects non-grantor trusts and beneficiaries, and why 2013 changes the game.

For individuals, the 3.8% tax will apply in 2013 to the lesser of net investment income or the excess of a taxpayer's modified adjusted gross income (MAGI) over:

- $125,000 (married filing separately)
- $250,000 (married filing jointly and qualifying widower)
- $200,000 (single) (individual thresholds in IRC §1411(b))

The "modified" applies to those who live abroad and use the foreign earned income exclusion – for 99% of taxpayers, this is the same as adjusted gross income (AGI), the bottom line of Form 1040.

For estates and trusts, it applies to the lesser of the undistributed net investment income or the excess of an estate/trust's adjusted (not modified) gross income (AGI) over

- $11,950 (top tax bracket, adjusted for inflation) (IRC §1411(a)(2))

"Net investment income" is
"A (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in paragraph (2),

(ii) other gross income derived from a trade or business described in paragraph (2), and
(iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in paragraph (2),
[Minus,]
(B) the deductions allowed by this subtitle which are properly allocable to such gross income or net gain."[158]

Qualified retirement income is excluded, as well as wages, self-employment income, active business income or gain from a sale of such a business.[159]

There are many basic ways of restructuring finances and investments to avoid the surtax, most of which also avoid/defer income tax, such as:

- using tax exempt investments such as municipal bonds;
- using investments or accounts with tax deferral features such as life insurance, deferred annuity contracts, deferred comp or retirement plans;
- utilizing traditional techniques to defer recognition/timing of gains, such as tax-free exchanges, installment sales or charitable remainder trusts;
- investing in assets with tax depreciation features, such as traditional real estate or oil and gas investments;
- more sensitive attention to tax recognition, such as using low turnover funds, ETFs and/or managing individual stocks and bonds;
- accelerating the timing of income recognition into 2012, via Roth IRA conversions, distributing C Corporation dividends or harvesting long-term capital gains;
- for decedent's estate/qualifying trusts, electing fiscal years ending/beginning in November, 2012 (the tax applies to years *beginning* after Dec 31, 2012, so a Dec 1, 2012-Nov 31, 2013 fiscal year allows eleven months of 2013 income to avoid surtax).

Most of these techniques are not new to the surtax and have traditionally been used for basic income tax planning. While some are effective planning for any year, overuse can simply become the "tax tail wagging the investment dog".

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[158] IRC § 1411(c)(1)
[159] IRC §1411(c)(2),(4),(5),(6)

This outline will discuss more unique opportunities and pitfalls of this new surtax and higher tax rates as applied to ongoing non-charitable, non grantor trusts,[160] through more proactive trust drafting, planning and administration. Without such planning, many trusts will get stuck paying a tax that might be easily avoided (or reduced). First, we'll set forth a typical example of the basic problem, then explore potential solutions to avoid the higher taxes.

The first example below assumes that all trust/beneficiary income is otherwise subject to surtax pursuant to IRC §1411(c) (i.e., interest, dividends, capital gains, annuities, rents, royalties, passive activity income, **not** retirement income, municipal bond interest, active business income, sale of active business or other exception) and any capital gains is not within a special tax rate category (such as depreciation recapture or 28% rate for collectibles).[161] The $100/$300 personal exemption and other common deductible expenses are ignored for simplicity, as well as any state income taxes.

CONSIDER: Barbara, recently widowed, is the primary beneficiary of a $2 million bypass trust established by her late husband. Her income outside the trust is $70,000. For 2013, the trust has ordinary income of $40,000 (which I have assumed to be also equal to the trust's accounting income and distributable net income (DNI)), short-term capital gains of $30,000, and long-term capital gains of $70,000. The trustee allocates all capital gains to trust principal. In its discretion, the trustee distributes to Barbara all of the accounting income ($40,000) as well as a discretionary distribution of principal of $75,000 needed for her support. The trust is entitled to a distribution deduction of only $40,000 and has *taxable income of $100,000* (the sum of its short-term and long-term capital gains).

The $75,000 principal distribution is not ordinarily included as part of what is called the "DNI deduction".[162] It is this latter aspect of trust income taxation that is often overlooked

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[160] It does not apply to fully charitable trusts or charitable remainder trusts – see page 135 of the Congressional Joint Committee on Taxation Report JCX-18-10, IRC §1411(e), Treas. Prop. Reg. §1.1411-3(b). This article will skip discussion of the surtax and higher rates as applied to estates, because it will often be less of a problem, due to recent step up in basis, higher than usual deductions such as attorney, executor and probate fees, and the fact that terminating estates pass out capital gains as part of DNI – but estates taking over a year to settle or pouring over into a trust will involve the same issues.

[161] See IRC §1(h) for special capital gains tax rates, IRC §408(m) for definition of collectibles. For an outstanding article on the 3.8% surtax applied to businesses owned by trusts/estates, see *20 Questions (and Answers!) on the New 3.8% Surtax*, by Richard L. Dees, Tax Notes, August 2013

[162] IRC §643(a)(3), Treas. Reg. §1.643(a)-3(a)

and misunderstood by practitioners, and is potentially the source and trap for higher tax. Once the trust is over $11,950 of taxable income (roughly $88,050 in this case), it is taxed at 39.6% (20% if LTCG/qualified dividends), plus, unless it meets an exception such as IRA or qualified plan distributions, it is also subject to the 3.8% surtax.[163]

Back to our example and the new effect of the higher rates and the surtax: beginning in 2013, all of that short term capital gains (after $11,950) is subject to top income tax rate (39.6%), **plus** the 3.8% surtax. All of the long-term capital gains is subject to a top long-term capital gains tax rate of 20%, **plus** the 3.8% surtax. Can we work some trust accounting alchemy allow capital gains to escape being trapped in the trust? In our example, *this may allow investment income to completely avoid the surtax* and lower taxes on short-term and long-term capital gains as well. This would subject the short-term gains to a mere 25% or 28% tax in the hands of the beneficiary (the lower rate would apply if Barbara is a qualifying widower or remarried), instead of 43.4% (39.6% +3.8% surtax), and subject the long-term gains to a mere 15% in the hands of the beneficiary instead of 23.8% (20% +3.8% surtax).

Potential tax saving in this example if no capital gains is trapped in trust (assuming remarriage or qualifying widow filing status, if not, savings slightly less):

23.8%-15% (8.8%) times total LTCG ($70,000) = $6,160

(amount of overall LTCG and surtax savings by taxing to beneficiary not trust)

plus

43.4%-28% (15.4%) times STCG ($30,000 -$11,950) = $2,780

(amount of STCG and surtax savings from taxing to beneficiary, not trust)

(for simplicity, we'll assume the first $11,950 taxed to the trust would generate approximately the same tax if taxed to the beneficiary)

Total Potential Tax Savings, Annually = $8,940

If a beneficiary is otherwise in the highest tax bracket (currently $400,000/yr single, $450,000 MFJ taxable income), then the fact that income is "trapped" in a bypass/marital trust in 2013 at the highest bracket, plus a 3.8% tax makes no difference - she would have

[163] For rules on how the surtax applies subchapter J principals to trusts, see Treas. Prop. Reg. §1.1411-3, which can be found online at http://www.gpo.gov/fdsys/pkg/FR-2012-12-05/pdf/2012-29238.pdf

paid that same level of tax anyway. Whether income is taxed to the trust or to such a beneficiary would usually be income tax rate and Medicare surtax-neutral. Most trust beneficiaries will not fit in this elite bracket of taxable income, however. And, even high-bracket taxpayers may have capital loss carry forwards that could soak up distributed capital gains.

But if distribution standards would otherwise require or permit significant distributions from principal to be made to the beneficiary, then why not arrange the accounting of those same distributions in the most tax-effective manner?

Some family situations, such as second marriages where a settlor wants the maximum proscription on the spouse's distributions and maximum remainder for beneficiaries, do not offer much in the way of flexibility. We are mostly left with standard income tax deferral techniques. But for many families, there are good options to avoid this fate of higher ongoing trust taxation, especially if we are in drafting mode or have not yet established any history of trust accounting and administration.

There are two main methods – 1) using IRC § 678(a) to allow the spouse to withdraw all or most net taxable income, specifically including all net capital gains or, usually better, 2) coming within one of the three exceptions in Treas. Reg. §1.643(a)-3(b) which allow discretionary distributions to carry out net capital gains. [164]

[164] Another less desirable method to pass out capital gains to beneficiaries is for the trust to invest in an entity taxed as a partnership. Cash distributed from an entity such as a partnership/LLC and paid to the trust is generally trust accounting income, even if the cash is derived from capital gains - Uniform Principal and Income Act, §401(b). Thus, because they are "properly allocated to income" pursuant to Treas. Reg. §1.643(a)-3(b)(1), they may be included in the DNI deduction and pass out to beneficiaries on the K-1 as any other income. This, of course, does not help if there are "phantom gains" or cash distributions are not sufficiently made from the partnership to the trust. To structure an entire portfolio in this manner is highly unwieldy. Assuming the other partner can be found and the fiduciary duties worked out, there would still be issues under IRC §2519 if it were a QTIP trust, and one can imagine other practical problems in managing a large portion of the trust in this manner – not to mention the additional tax reporting.

IRC §678(a) and the "Beneficiary Income-Controlled Grantor Trust" – A trust that merely directs all net income be paid, or even pays all taxable income, to a beneficiary, is NOT triggering §678 – such trusts must report under the 1041/K-1 Subchapter J tax regime.[165] To be taxable directly to the beneficiary, and reported directly on the beneficiary's Form 1040, the beneficiary must have an unfettered right to withdraw the taxable income in question (not limited to an ascertainable standard, or with required consent of another party). This paper will refer to such trusts as "Mallinckrodt trusts", or simply, "§678(a) trusts".[166] Let's first walk through how IRC §678(a) works, then distinguish such trusts from a related but different variant, the "beneficiary defective inheritor's trust (BDITs)", and then explore some of the possibilities and limitations of such structures.

IRC §678(a) requires that a beneficiary be considered the owner of ***any portion*** of a trust when a beneficiary has the power to withdraw income:

> **a) General rule**
> A person other than the grantor shall be treated as the owner of ***any portion*** of a trust with respect to which:
> **(1)** such person has a power ***exercisable solely by himself*** to vest the corpus ***or the income therefrom in himself***, **or**
> **(2)** such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject to grantor of a trust to treatment as the owner thereof.

Many practitioners mistakenly interpret §678 without the "or" in §678(a)(1), as if it ***only*** applies when the beneficiary has (or had) the right to withdraw the *entire principal* (corpus) of the trust.[167] This is a commonly accepted myth, but understandable, since there

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[165] In Subchapter J, Subparts A-D, IRC §641-669, control most traditional trust tax accounting, Subpart E is the grantor trust rules, §671-679.

[166] *Mallinckrodt Trust* is a term named after the seminal case of *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945), which Congress basically codified in IRC§678 in 1954.

[167] This is probably due to, but not the fault of, recent popular articles about "beneficiary defective inheritor's trust" (BDIT) techniques, which attempt to use third party created trusts with Crummey withdrawal rights and lapses to create irrevocable trusts post-lapse that are taxed for income tax purposes to the current beneficiary, *even if the beneficiary has no current withdrawal right*. Their use is limited because of the $5,000/5% lapse limitation of IRC §2041, but they are a creative use. Those techniques hinge on using §678(a)(2), in conjunction with §678(a)(1). This article focuses on a different but related variant of this concept, *where the beneficiary has a current withdrawal right over taxable income*. For great "BDIT" material, see *Gift From Above: Estate Planning On a Higher Plane*, Trusts and Estates, November 2011, by Richard A. Oshins, Lawrence Brody, Jerome M. Hesch & Susan P. Rounds; *The BDIT: A Powerful Wealth Planning Strategy When Properly Designed and*

have been extremely few reported cases or rulings on trust structures that only allow withdrawal powers over income and treatises have very little if any discussion of this potential variation, for the logical reason that practitioners don't normally draft trusts this way.[168] ***Yet***. But there is no reason to ignore the "or" in the statute and no requirement under §678 that a beneficiary/powerholder have any power over corpus whatsoever. In fact, the seminal case that the statute itself was based on had no beneficiary right to withdraw underlying principal.

For instance, a trust may provide that the primary beneficiary has the unfettered right to withdraw all net income.[169] Unless defined otherwise in the trust, this means the beneficiary is taxed only on fiduciary accounting income (dividends, interest, rents), but not necessarily all taxable income. For instance, an IRA distribution might be 100% *taxable* income, but 10% *accounting* income, and capital gains would not usually be accounting income either. Conversely, a trust might grant a beneficiary a withdrawal right over income attributable to principal, but not accounting income, and this would shift only that income (e.g. *not* the interest, dividends, rents) to the beneficiary.[170] But a trust could easily define the withdrawal right to include capital gains or taxable income from a particular asset, or *all assets* of a trust. Courts must look to the definition of income in the withdrawal right under the trust instrument, and if a beneficiary can withdraw capital gains, then the beneficiary must report the capital gains.[171] It is not optional to report or have the trust pay the tax.

Implemented, LISI Estate Planning Newsletter #1824 (June 22, 2011), by Dick Oshins, Larry Brody and Katarinna McBride; *A Balanced Solution*, Trusts and Estates, May 2011, by Steven Gorin

[168] Treatises consulted include *Federal Income Taxation of Estates and Trusts*, 3rd edition, ¶12.01-12.05, Zaritsky and Lane, BNA Portfolios 858-2nd and 852-3rd *Grantor Trusts: Sections 671-679*, by Howard Zaritsky, *Income Taxation of Trusts and Estates*, by Alan Acker, and *Federal Taxation of Trusts, Grantors and Beneficiaries*, by J. Peschel & E. Spurgeon

[169] There are colorable arguments that a sole beneficiary/trustee might also trigger §678(a) even when limited by an ascertainable standard, but this is debatable and generally unreliable for proactive planning purposes. Most cases (and you can find many by shepardizing the *Mallinkrodt* case) find that even the slightest limitation will take a powerholder out of grantor trust status. This paper will assume there are no forfeiture provisions, consent requirements, duties or purposes otherwise fettering the right. See pages 17-20 of Howard Mobley's outline at http://www.howardmobley.com/articles/FixingBrokenTrusts.pdf and Jonathan Blattmachr, Mitchell Gans and Alvina Lo's article at http://ssrn.com/abstract=1511910. Also, read the surprising conclusion of the penultimate paragraph of *Koffmann v. U.S.*, 300 F.2d 176 (6th Cir. 1962).

[170] Treas. Reg. §1.671-3(b)(2)

[171] For example, in *U.S. v. De Bonchamps*, 278 F.2d 127 (9th Cir. 1960), the court found, in interpreting 678, that a life tenant should not be taxed on the income because they did not have the sole power to take the capital gains upon sale of the underlying asset. "We have concluded that, upon the record before us, the powers of these life tenants are not the equivalent of a power to vest in themselves the corpus of the estate ***or*** the capital gains in

Refusing to take the income is not relevant to the analysis, nor is renouncing the right to prior income.[172] Although the power is probably effective for §678(a) regardless of a beneficiary's capacity, it would be prudent to specifically allow an agent under a durable power of attorney or court-appointed conservator or guardian to exercise the right.[173]

If a trust has a 5% of corpus withdrawal power, then 5% of the taxable income should be reported on the powerholder's Form 1040 (regardless of whether it lapses or is taken). If the powerholder has the power to withdrawal up to $30,000 from taxable income, then that much should be reported directly on the powerholder's Form 1040.[174]

The granddaddy of all grantor trust cases, *Mallinckrodt,* from which Congress basically codified in 1954 into IRC §678, concerned a father who established a trust for his son, his son's wife and their children.[175] The son's wife was to get $10,000/yr, and the son could withdraw any income above that. The trustee reported all the income, including the undistributed income that the son could have withdrawn but did not, and deducted the $10,000 distribution to the wife. The court held that reporting of income/deduction for the $10,000 was proper, but that the undistributed income that the son could have withdrawn, but did not, must be reported on his tax return as income:

> [The] "power of the petitioner to receive this trust income each year, upon request, can be regarded as the equivalent of ownership of the income for purposes of taxation.*** income is taxable to the possessor of such power, and that logically it makes no difference whether the possessor is a grantor who retained the power or a beneficiary who acquired it from another.*** Since the trust income in suit was available to petitioner upon request in each of the years involved, he had in each of

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question." (emphasis added, the court clearly implying that if they could have taken the capital gains, though not necessarily the entire corpus, it would have been taxed to them).

[172] *Grant v. Commissioner*, 174 F.2d 891 (5th Cir. 1949).

[173] Generally GPOAs are unaffected by a powerholder's incapacity, see footnote 69, and §678(a) should follow.

[174] In *Townsend v. Commissioner*, 5 T.C. 1380 (1945), the beneficiary, pursuant to a state court order after a dispute, had the unfettered right to withdraw up to $30,000 annually, and the tax court held this much must be reported directly on the powerholder/beneficiary's tax return.

[175] *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945), this same reasoning is followed in other cases where beneficiaries had no withdrawal right over the entire principal, but only the income. E.g. *Spies v. United States*, 180 F.2d 336 (8th Cir. 1950), *Goldsby v. Commissioner*, T.C. Memo 2006-274 (where taxpayer/beneficiaries attempted to get an individual charitable deduction, arguing that a conservation easement contribution from the trust came from income taxable to the beneficiary under §678 – the tax court found that 678(a) applied, and a charitable deduction would be allowed if it came from a taxpayer's grantor trust portion, but ultimately denied the deduction since the contribution was not traced to income. The parties and court inexplicable ignored §678(a)(2), which may have helped the taxpayer get a pro rated deduction).

> those years the "realizable" economic gain necessary to make the income taxable to him."[176]

While *Mallinckrodt* did not specify or discuss whether capital gains was included in the trust's definition of withdrawable income, it is clear from the case that if it were, it would be taxable to the powerholder. Another irrevocable trust from a recent case had this clause:

> "The net income from said trust shall be distributed by the Trustee to the beneficiaries [petitioner and Kathleen], jointly or the survivor of them, not less than once each year * * *. Provided, however, the Trustee shall distribute only that part of the net income which is derived from Capital gains as is requested each year by the beneficiaries and if no such request be made then all of such capital gains shall be retained as a part of the Trust fund and be reinvested as principal."[177]

The beneficiary did not request and the trust did not distribute the capital gains income, although the beneficiary could have clearly requested it. Citing *Mallinckrodt*, the tax court held that:

> "Section 678(a)(1) clearly provides that a person with the power, exercisable solely by himself, to vest the corpus or the income in himself will be treated as the owner of that portion of the trust over which his power exists. Here, Kathleen and petitioner had the power exercisable solely by themselves to receive the King Trusts' capital gains income. Accordingly, pursuant to section 678(a)(1), petitioners are deemed to be the owners of the capital gains income from the King Trusts."[178]

Thus, with the plain language of §678 and longstanding case precedent, it's clear that beneficiaries with withdrawal rights over trust income (including net capital gains) MUST report any such income on their Form 1040 – failure to do so may lead to substantial penalties, especially since *there is no substantial authority to argue otherwise*.

To understand the practical basics, let's go back to Barbara's bypass trust in our example above: with a fully §678(a) trust in which Barbara can withdraw all taxable income, including capital gains, Barbara would simply report all $140,000 of taxable income on her Form 1040 regardless of what she actually receives, and *the trust has no income*.[179] A trust could be partially subject to §678(a). If Barbara only had an unfettered right to withdraw

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[176] *Id*. at 5
[177] *Campbell v. Commissioner*, T.C. Memo 1979-495
[178] *Id*.
[179] Or, more accurately, no income to report under Subparts A-D of Subchapter J, but under Subpart E grantor trust

accounting income (interest, dividends, rents), then $40,000 would go onto her Form 1040 (ultimately, the same as if it had been K-1'd), and deductible expenses would have to be pro rated accordingly.[180] If Barbara sends some of her withdrawable income to charity, she (not the trust) would be eligible for a Schedule A tax deduction under §170.[181]

A fully "beneficiary income-controlled" or "beneficiary-defective" §678(a) grantor trust does have a few advantages, and may be useful in specific situations. For instance, it may be preferable that certain assets, such as a personal residence, non-qualified annuity or qualifying small business stock, be owned by a §678(a) trust, because of the preferred tax treatment that individual Form 1040 taxpayers may avail themselves of that non-grantor trusts simply can't.[182] Surprising to many people, estates and non-grantor trusts are not eligible for the juicy $500,000 §179 expensing depreciation deduction – that alone should be a reason to allow for toggling to a beneficiary defective status for portions of the trust attributable to a capital intensive pass through entity business.[183] Grantor trusts are also eligible S corporation stockholders, regardless of whether there is a QSST or ESBT election, but it cannot be partially grantor as to accounting income only.[184] Though more rare, provisions for taking $50,000/$100,000 ordinary rather than capital losses for sales of small business

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[180] See various portion rules discussed in Treas. Reg. §1.671-2 and §1.671-3, some expenses might be attributed to the asset producing the income, and some, like a trustee fee, might be prorated.

[181] *Goldsby v. Commissioner*, T.C. Memo 2006-274

[182] Arguably, a §678(a) trust would make it more convincing that a trust is an "agent for a natural person" per IRC §72(u), so as to be closer to PLR 2003-23012. For a good discussion of this see *The Advisor's Guide to Annuities*, Michael Kitces and John Olsen's *The Annuity Advisor*. Non-qualified annuities, perhaps even more so than IRAs/QPs, are best left to spouses outright unless the negatives of outright bequest (higher state estate tax, protection for other family, vulnerable spouse, etc.), outweigh the income tax benefits potentially lost by using a trust (which will depend on the gain in the contract). For small business stock exclusion and rollovers, see IRC §1202 and §1045

[183] IRC §179(d)(4), although if the income is going to be earmarked to a specific beneficiary, then a QSST election may solve the issue if an S corp– QSSTs are in many ways de facto §678(a) trusts, see e.g., Treas. Reg. §1.1361-1(j)(8), but the §678(a) solution may be a good solution for an LLC/LP taxed as a partnership. The generous $500,000 expensing provision is temporary- the law is due to revert to $25,000 in 2014, but Congress may extend or modify that amount and there are various bills proposed to do so.

[184] IRC §1361(c)(2)(A) "the following trusts may be shareholders: **(i)** A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States." Subpart E of part I of subchapter J is referring to IRC §§671-679, which includes §678(a) of course. PLR 2012-16034 recently followed this, ruling that a beneficiary-grantor trust created via Crummey power qualifies as an S corp shareholder. Conservative practitioners may want to file a QSST election as a "belt and suspenders" approach, but this is a great back up in case that election failed to be properly filed. For most purposes, except perhaps for sale of the stock (where the QSST would no longer be treated as a grantor trust), it is the same for income tax purposes.

stock are unavailable to trusts, but should be available to a beneficiary under a §678(a) structure.[185]

In fact, there is no reason that the trust cannot provide different standards for income from these special assets (beneficiary withdrawal as opposed to trustee distribution), in some cases as a separate subtrust, but you would not necessarily have to. The most common of these to encounter, the capital gains exclusion on principal residence, should be recognized in a §678(a) trust and such a provision as to income over only certain assets would avoid many negatives.[186] For example, there is very little asset protection risk granting a beneficiary the right to withdraw capital gains income from sale of a personal residence if an independent trustee doesn't sell the property! A trust might allow the beneficiary to withdraw net capital gains from the sale of a residence, but have ordinary distribution provisions for all other assets.

Another unique advantage of using §678(a) over using DNI distributions to shift income to the beneficiary from the trust is the ability to limit it to *taxable* income. Let's change our example above so that $30,000 of the $40,000 trust income is from municipal bonds – tax exempt income. A §678(a) power can be over all assets except the muni bonds, allowing the tax-exempt assets to stay trapped in trust without requiring withdrawal or deemed withdrawal (to the extent no additional distributions are made). This cannot be done with ordinary trust distributions, which must carry out non taxable income as well as non-taxable income.

Many practitioners already segregate IRA/qualified plan assets into separate or even standalone trusts for various tax and administrative reasons.[187] Taxpayers may need to use such special assets to fund a trust to exploit the state's estate exclusion amount, and making it a beneficiary-defective trust as to the income generated therein may be a significant benefit,

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185 See IRC §1244, Treas. Reg. §1.671-3(a) and (a)(2)

186 See Rev. Rul. 66-159, Rev. Rul. 85-45 and PLR 1999-12026, in which the IRS looked through the trust to the beneficial owner under 678(a) for qualification under IRC §121 and its predecessor. Although in those cases the beneficiary had a right to withdrawal the entire trust principal, not just the capital gains from the sale of the home, they should apply to extend the exclusion if all the capital gains are available to withdraw. This is perfectly consistent with Treas. Reg. §1.671-3(a)(2) and §678(a). That said, a conservative practitioner may want to get a PLR, or pay tax and file for refund, but there is certainly substantial authority for the position.

187 See *Using Separate or Stand Alone Trusts to Receive Retirement Benefits*, Edwin Morrow, Journal of Retirement Planning, Sept 2007

even if it is slightly more "leaky".[188] This asset protection drawback and inherent "leakiness" might be partially mitigated through a Crummey/hanging power wherein the beneficiary merely has a power to withdraw the taxable income and to the extent it is not withdrawn, the power lapses annually over 5%.[189] Not to mention the investment policy of the trust.

Unlike a Crummey clause, forfeiture provisions (usually embedded in a more robust spendthrift clause) can automatically cut off such a withdrawal right that is not needed to qualify for the annual gift tax exclusion in the event of creditor attack (with appropriate carve out for QSST/marital/conduit trusts), or a trust protector provision might do so as well. To keep within the §678(a) "sole" power requirement, and improve asset protection, withdrawal rights can be limited to a window in time (e.g. December 15-31), and such provisions should probably only become effective prospectively so as not to impugn the "sole power".

There is no reason that a §678(a) power has to be all or nothing, or even the same every year! It can be more targeted than the traditional distribution structure under Subchapter J, which does not allow tracing of types of income. For example, say a trust grants the beneficiary the unfettered withdrawal right to all income attributable to all assets *except* the municipal bond portfolio, the stock portfolio and the Roth IRA. This leaves income from those assets (0%, 23.8% for LTCG/QD, 0% respectively) in trust, and shifts taxation of the rent, traditional IRA and taxable interest to the beneficiary. This may cut the rate on that from a 43.4% rate to a likely 15%, 25% or 28% taxed to the beneficiary.

This withdrawal power could also be capped – e.g., all income attributable to assets other than the muni bond portfolio above $12,150, or even reference an external criteria, though it certainly *complicates administration*, such as income to a point until his/her taxable income exceeds $400,000/$450,000 top income tax bracket. Remember this also forces a

[188] For instance, someone in Seattle could easily have a $1 million home, $1 million in other assets, and wants to fund the entire $2 million to exploit the $2 million because their spouse has the same amount of assets – not funding the bypass with the home might cause $200,000 or so in additional state estate tax. State-only QTIP trusts have the same issue. Washington state has a $2 million estate tax exclusion with 10%-20% rates.

[189] IRC §2514(e). However, the 5% would pertain to the taxable income available to withdraw, not the entire principal, as some authors in this area have assumed – see Rev. Rul. 66-87. If a beneficiary has the right to withdrawal $120,000 of income from a $2 million trust corpus, and does not take it, the lapse protection is $6,000, not $100,000. The lapse protection may differ for state creditor protection law than federal tax law. In many states, the protected amount in the above scenario would be $14,000 or $28,000, depending on whether the original donor was married at the time. UTC § 505(b), though many UTC states double the annual exclusion lapse protection, as in Ohio R.C. §5805.06(B)(2), and some may omit it (Massachusetts).

portioning of any expenses, such as investment management/trustee, attorney fees, though directly attributable expenses (e.g. real estate taxes on the residence) may go with the §678(a) beneficiary (or non-grantor trust portion, as applicable).[190] Any structure with withdrawal rights over only certain types of assets would have issues if the beneficiary were the controlling investment trustee, and fiduciary duties and conflicts would have to be worked around even with an independent trustee, but it's not insurmountable.

Despite the above possibilities, by far the most likely use for this is a family that wants to SIMPLIFY trust administration and accounting and ensure they could not be "worse off" income tax wise with a trust. This means a withdrawal power over **all** taxable income. Such a provision can eliminate a traditional 1041 filing, even though grantor trusts still have nominal reporting requirements.[191]

While §678 withdrawal provisions shift the income taxation (and with it, the Medicare "surtaxation"),[192] such powers bring up some negative ramifications:

- some slightly decreased asset protection (amounts currently subject to an unfettered withdrawal power are typically subject to the beneficiary's creditors), but a forfeiture or shifting executory interest clause and/or trust protector might easily cut that off to prevent much ongoing damage. An automatic provision is preferred to avoid fraudulent transfer issues, but a trust protector enables modification when no threat is imminent.[193]
- slightly increased estate inclusion (amounts subject to withdrawal at death are in a beneficiary's estate), but again, this can be mitigated so that the withdrawal right is not until the end of the year. A beneficiary would be unlikely to die with any includible right.
- if assets are *not* withdrawn in a given year, it may result in a partially self-settled trust as to the beneficiary, which may have negative ramifications for asset protection or estate tax inclusion. However, a beneficiary might simply withdraw any amounts above the 5/5 and/or state creditor lapse protection and if asset protection is desired, contribute it to an IRA/Qualified Plan, life insurance, LLC, DAPT, gifting trust or other protective structure.

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190 Treas. Reg. §1.671-3(a)(2)

191 See Treas. Reg. §1.671-4 for various alternative methods of grantor trust reporting compliance.

192 Treas. Prop. Reg. §1.1411-3(b)(5)

193 See discussion of UFTA issues with trust protector/decanting at *Ferri v. Powell-Ferri: Asset Protection Issues, Perils and Opportunities with Decanting*, Ed Morrow & Steve Oshins, LISI Asset Protection Newsletter #240

Most tax preparers and many attorneys are simply not educated on these concepts or prepared to evaluate such trusts, so if a separate subtrust or other §678 type provisions are added that deviate from the norm as discussed here, add an explanatory sentence or two (in bold, not buried in the boilerplate) describing the intention of the clause and its intended tax effect.

Special Needs Trusts

It is probably stating the obvious, but a §678(a) power would not work in a special needs trust scenario. Although in theory one could give such a §678(a) power to a sibling or someone other than the special needs beneficiary, this is probably contrary to the settlor's intent, impairs protection for the special needs beneficiary, and may cause *higher* income taxation among the family unit – not only would a special needs beneficiary getting a K-1 be in a lower bracket typically, but qualifying non-grantor trusts for special needs beneficiaries (a "qualified disability trust") even receive an additional personal tax exemption.[194]

What about QTIP trusts?

The common wisdom is that QTIP require all income be paid annually to the surviving spouse, therefore a QTIP cannot be a fully §678(a) trust. Once again, the common wisdom is wrong. Rather than mandate all income be paid annually, marital trusts can merely require that the spouse be able to withdraw all income annually.[195] As discussed above, this can make a huge difference under Subchapter J. This floor of the right to withdraw net accounting income required by IRC §2056 can certainly be increased to include the greater of the net accounting income or the taxable income (which would usually be higher), including capital

[194] IRC §642(b)(2)(C), tied to personal exemption, $3950 in 2014, rather than $100 for typical complex trusts.

[195] Treas. Reg. §20.2056(b)-5(f)(8): "In the case of an interest passing in trust, the terms "entitled for life" and "payable annually or at more frequent intervals," as used in the conditions set forth in paragraph (a) (1) and (2) of this section, require that under the terms of the trust the income referred to must be currently (at least annually; see paragraph (e) of this section) distributable to the spouse **or** that she must have such command over the income that it is virtually hers. Thus, the conditions in paragraph (a) (1) and (2) of this section are satisfied in this respect if, under the terms of the trust instrument, *the spouse has the right exercisable annually (or more frequently) to require distribution to herself of the trust income, and otherwise the trust income is to be accumulated and added to corpus*." Treas. Reg. §20.2056(b)-7(d)(2) governing QTIPs looks to the above Reg for its definition of the required income interest: "(2) Entitled for life to all income. The principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust."

gains, or other taxable income that would not be accounting income (e.g., a $50,000 IRA payment might be $5,000 accounting income, but $50,000 taxable income).

How viable is this? It largely depends on what the settlor would want. Many, even in some blended families, would be fine with this, and it could arguably allow for a much easier to understand and simplified reporting structure. Normal people think in terms of taxable income, not "DNI" and "FAI". No surviving spouse thinks that the $50,000 IRA distribution from the $1 million IRA should entitle him or her to only $5,000 of "income". The pressures on the trustee might be slightly different – instead of a surviving spouse insisting on high-yield, income producing property, the focus might shift to realizing long-term capital gains! Like anything new, it would require thinking through the prior modus operandi. But explaining the income taxation to clients would be *infinitely* easier. If you don't agree, you've never taken a fiduciary income tax course or tried to explain trust taxation to a client.

Transactions between beneficiaries and fully §678(a) trusts as to beneficiaries

Many readers are undoubtedly wondering – since these techniques can create what is considered a grantor trust to the beneficiary as to ALL trust income, what is to stop beneficiaries (with the possible exception of QTIP trust beneficiaries), from engaging in installment sales, swaps or other transactions with their fully §678(a) trusts under Rev. Rul. 85-13 and its progeny? Isn't this like the *BDIT* (which relies on lapses of powers of the entire corpus per §678(a)(2)), but with an unlimited seed gift, rather than a mere $5,000, and with less risk? Isn't this much more certain than an installment sale to a completed gift asset protection trust with the settlor as beneficiary, with its attendant §2036 risk? Comparing "beneficiary income controlled trusts" transactions with installment sales to BDITs, QSSTs and other grantor trusts will be considered in a separate article.

Using Treas. Reg. §1.643(a)-3(b) - The best solution to solving the capital gains tax trap in most cases is to utilize one of the three methods noted in the Treasury Regulations to allow capital gains to be treated as part of the DNI deduction. This will allow any discretionary distributions to the beneficiary to carry out capital gains as part of DNI so that the K-1 can take care of the surtax and higher tax rate issue by putting the capital gains on the *beneficiary's* Form 1040.

Once capital gains are part of the DNI deduction, they can be carried out on the K-1 and taxed to the beneficiary. So, how do we get out of the default rule that capital gains are not ordinarily part of DNI?[196] Generally, they will be included if they are 1) allocated to fiduciary accounting income or 2) allocated to principal and "paid, credited or required to be distributed to any beneficiary during the year".[197] The regulations regarding these exceptions are more specific and merit full inclusion here:[198]

> "(b) *Capital gains included in distributable net income.* Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)—
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph §1.643(a)–3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary."

Let's discuss these out of order, taking the easiest and "cleanest" first. The second method, (b)(2), is very straightforward. The trustee simply treats capital gains consistently as part of the beneficiary's distribution. Ideally, language in the trust will address this, which

[196] See Treas. Reg. §1.643(a)-3(a) for this default
[197] IRC § 643(a)(3)
[198] Treas. Reg. 1.643(a)-3(b)

might even give some cover in case the trustee failed to be consistent.[199] For new estates and trusts, this is quite easy. For an existing trust, there is a question whether it can change this practice when in prior years it has been consistently NOT treating capital gains as part of a beneficiary's distribution.[200] Potential remedies of amendments and decanting will be further discussed below.

The third method, (b)(3), is more problematic. It can be divided into two methods – the first is to "actually distribute" capital gains. This presumably means tracing the proceeds. So, the trustee takes the proceeds from the sale and gives the net capital gain therefrom to the beneficiary. This sounds easier than it is. For instance, what if principal distributions are needed early in the year and cannot wait until later when the net gains can be determined? What about "phantom" capital gains?

In lieu of tracing, the third method also allows capital gains to be part of DNI if the trustee uses capital gains "in determining the amount that is distributed or required to be distributed". Very few trusts would use capital gains as part of a distribution provision in this manner. For instance, a trust might say that "gains from the sale of a particular business property shall go to beneficiary X." In theory, the trust could mandate that "the trustee pay all (or X%) of net income and net capital gains to the beneficiary" to invoke this section, but if these were the goals, it would make more sense to use §678(a), not §1.643(a)-3(b)(3).

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[199] Example: "To the extent that discretionary distributions are made from principal, the trustee shall make them and/or account for them in the books, records and tax returns of the trust in the following order:
1) from any current year net short-term capital gains, except those net gains attributable to disposition of property held in a trade or business not described in IRC §1411(c)(2), or attributable to disposition of an active trade or business as described in IRC §1411(c)(4);
2) from any current year taxable income attributable to assets described in IRC §1411(c)(1)(A)(i), such as an annuity payment, that was allocated to principal.
3) from any current year taxable income attributable to a qualified retirement plan distribution described in section 401 (a), 403 (a), 403 (b), 408, 408A, or 457 (b) allocated to principal
4) from any remaining current net short term capital gains not described in paragraph 1
5) from any current long-term capital gains, except those net gains attributable to disposition of property held in a trade or business not described in IRC §1411(c)(2), or attributable to disposition of an active trade or business as described in IRC §1411(c)(4);

[200] Most recently, the IRS recognized this problem but was quite cold-hearted about it: "If the tax imposed by section 1411 had existed in the year that an existing trust or estate had first incurred capital gains, the fiduciary may have exercised its discretion differently. The commentators request that the final regulations allow a fiduciary a "fresh start" to determine whether capital gains are to be treated as part of DNI. *The final regulations do not adopt this suggestion.*** the potential for fluctuations in the effective tax rate on capital gains is a factor that is foreseeable by fiduciaries making these elections*." You should have known something like ATRA would pass?!!!! From page 33-34 of the final §1411 regulations at https://s3.amazonaws.com/public-inspection.federalregister.gov/2013-28410.pdf

What if the trustee doesn't mandate that capital gains be used in determining the distribution, but the trustee simply states "I hereby swear I considered capital gains to determine how much to distribute from this trust this year"? Some attorneys are more optimistic than I that mere trustee policy can be relied on to come under (b)(3), but arguably it only requires "utilization by the fiduciary", not any required mandate in the document.[201] Perhaps it would be more certain if the trust document specifically required or at least permitted the trustee to consider capital gains, something like "in exercising the trustee's discretion to distribute principal, my trustee may [shall?] consider any capital gains realized by the trust as a relevant factor in determining any amount pursuant to its discretionary decision." Detractors might say that using "shall" restricts the trustee's ability to NOT consider capital gains in future years if (b)(3) were desired to be avoided. A non-judicial (private) settlement agreement may be a good solution here to add such a sentence.

The first method, (b)(1), offers more flexibility than the latter two, but potentially offers more complexity and liability for the trustee, because it involves changing the scheme of principal and income allocation and requires additional trustee discretion.

For many modern trusts, the distinction between principal and income is anachronistic. These distinctions are often meaningless in determining what beneficiaries receive from the trust. However, they are still important for tax purposes.

Corollary to the above regulation, Treas. Reg. §1.643(b)-1 states that:

> "In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected **if** the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law."[202]

[201] See *Including Capital Gains in Trust or Estate Distributions After ATRA - A frequently overlooked regulation may give fiduciaries more flexibility than they realize*, Trusts and Estates, March 2013, by Frederick Sembler.

[202] This is in spite of an admonition earlier in the same regulation that "Trust provisions that depart fundamentally from traditional principals of income and principal will generally not be recognized". This ability of the fiduciary to "manipulate" tax consequences through its discretion pursuant to this regulation has generally been respected. See BNA Portfolio 852-3rd, Acker, A67 and authorities cited therein.

Thus, in theory, not only could capital gains be allocated to income, but it can be done at the trustee's discretion. Sections 103-104 of the Uniform Principal and Income Act, which provides the default principal/income rules in most states, allow a trustee to make adjustments to income and principal, *in theory*. However, the default prerequisites and rationale for invoking these provisions do not fit our proactive tax planning example above, where the goal is simply to shift taxation of the capital gains that is arguably already being distributed to the beneficiary.

But this does not mean that a trust cannot be drafted to override Section 103-104's limitations. Section 103(a)(1) first requires a fiduciary to "administer a trust or estate in accordance with the trust or the will, even if there is a different provision in this Act". Section 103(a)(2) further permits a trustee to "administer a trust or estate by the exercise of a discretionary power of administration *given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this Act*." Thus, the attorney merely has to override the UPIA default to grant wider discretion to allocate between principal and income (perhaps, to the extent of discretionary distributions), while keeping in line with both state law and Treas. Regs. §1.643(b)-1 and §1.643(a)-3(b).[203]

Discretion to exploit such adjustments is best done by an independent corporate trustee, rather than a beneficiary/trustee, especially if there is "all net income" language. So, how would our power to adjust solution work under our bypass trust example above? The independent trustee would adjust all (or most) of capital gains to accounting income, then the $75,000 distribution becomes part of DNI and the distribution deduction is K-1'd out to the beneficiary, taxed at her much lower rates.

Comparing the three methods under §1.643(a)-3(b) – the second method (b)(2) is the simplest and probably preferred for most new trusts without any inconsistent past reporting.

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[203] Example: "Pursuant to Section 103 of the UPIA [or state UPIA citation], I hereby override the state law default treatment of allocation of capital gains to trust principal as follows: any Trustee not a beneficiary nor "related or subordinate" (as those terms are defined in IRC § 672) to any beneficiary of a trust may reallocate capital gains taxable income from fiduciary accounting principal to fiduciary accounting income in the sole discretion of the trustee. In doing so, the trustee may consider the net tax effect of the allocation to the trust and the beneficiary together, such as whether leaving capital gains as taxable to the trust would otherwise cause a Medicare surtax or short-term capital gains rates in excess of the net additional tax effect of a reallocation on a beneficiary's taxes."

The first method (b)(1), may offer more flexibility, but there would be the additional complexity of changing internal trust principal/income accounting. Plus, how much guidance do we have on what is "reasonable and impartial" (more an issue for "all net income" trusts)? The third method, (b)(3), seems easier, and promising if the trust has language requiring consideration of capital gains in the distribution decision, but is still uncertain for my tastes as far as how the IRS will actually police that "utilization".

Problems with Adapting Irrevocable Trusts with Prior Tax Reporting History

In the case where a trustee has been historically **not** been treating capital gains as part of distributions in its "books, records, and tax returns", query whether a private settlement agreement, decanting or other reformation to prospectively change this would have any impact, for instance incorporating something akin to the sample language above? Arguably, the trustee would *thereafter* be consistent in its treatment of capital gains *pursuant to the new governing instrument*. Would the IRS permit a one-time change? The IRS may not consider it to be a new trust for Treas. Reg. §1.643(a)-3(b) purposes simply because of a minor administrative amendment, and might therefore regard new treatment of capital gains as *inconsistent* with prior practice. After all, trustees don't typically get a completely new EIN for such changes. Therefore, practitioners might seek a private letter ruling to adapt existing trusts that have a history of not treating capital gains as part of distributions, or use one of the other methods mentioned herein, such as changing the principal and income scheme.

Impact of changing tax burden on beneficiary distributions

If capital gains are considered part of Barbara's distribution and ordinary non-grantor trust rules are applied, the $40,000 of accounting income and the $75,000 of principal distribution is also taxed to her and only $25,000 of capital gains is left trapped in trust. However, because of her extra personal tax burden, she would probably ask for approximately $20,000 in additional distributions to compensate, which would lower the income trapped in the trust to well under $11,950. Thus, the 43.4%/23.8% highest marginal trust tax rate is completely avoided and her personal rates of 28%/15% would be applicable. This can lead to tremendous ongoing tax savings. Even the remainder beneficiaries are happy because, although Barbara got $20,000 more in gross distributions under this planning, the trust saved more than that in taxes, so they are better off as well.

Whether these techniques will save taxes depends on many factors, primarily the trust distribution provisions, state principal and income law, state taxation, preexisting tax attributes such as capital loss carry-forwards of the trust and beneficiary, and of course, the beneficiary's income and deductions. However, in many cases of trust planning and administration for the vast majority of taxpayers, it will pay to rethink the trust boilerplate, administration and tax preparation as regards to capital gains starting in 2013.

Practitioners should review the terms of their trusts for discussion of how capital gains are accounted for in making trust distributions and/or allocated to fiduciary accounting income. For existing irrevocable trusts, attorneys should not only review the terms of the trusts as to how capital gains are accounted for, but they should also review how the trustee has historically handled the treatment of capital gains regarding the beneficiary's distributions (Forms 1041 and K-1). An experienced corporate trust department would best ensure consistent documentation of the "books, records and tax returns" to comply with the regulations necessary to exploit these potential savings.

If the trustee has not been treating capital gains as a part of the beneficiary's distributions (which is likely), consideration should be given to a private settlement agreement or reformation to either correct prospective treatment of capital gains on the "books, records and tax returns" of the trust, or, better, amend the trust provisions regarding allocating capital gains to fiduciary accounting income and/or require consideration of capital gains in the trustee's discretionary distribution decision-making. In the latter cases, a professional and independent trustee or co-trustee should be considered to properly exploit this flexibility. Professional trustees HAVE to paper the file, for the OCC or state auditors and internal accounting committees, with their considerations for discretionary decisions.

Exploiting Spray Powers and Lifetime Limited Powers of Appointment - Even better than having capital gains taxed to the beneficiary, the settlor may give additional spray powers to the trustee, to spray income to other beneficiaries, including the family's favorite charity, donor advised fund or private foundation.[204] Or, probably better in many ways, the settlor may give the surviving spouse or another party a limited lifetime power of appointment.[205] For instance, let's say Barbara receives more income outside the trust, putting her in a higher bracket, and decides that she only needs $30,000 from the trust, but her children could use funds to pay for grandchildren in college. She uses her limited power of appointment, or asks the trustee or collateral powerholder to spray $80,000 to her children (or grandchildren) and $20,000 to the family's donor advised fund at the local community foundation that John had also named in the trust as a permissible appointee/beneficiary.[206] Whether this makes sense depends on the family situation, trust and brackets of the parties involved (and potentially the assets, such as whether an S Corp or IRA is involved, which

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[204] Spray powers have practical issues that require careful drafting to protect the primary beneficiary and prevent a sense of entitlement by secondary beneficiaries. Typically language would be completely discretionary and instruct the trustee to consider secondary beneficiaries only after consideration of the primary beneficiary's needs, or give the primary beneficiary (e.g. spouse) a veto power over secondary beneficiary distributions. Spray powers may also implicate additional reporting/accounting requirements.

[205] This should not cause estate inclusion, nor a taxable gift, if it is properly circumscribed with support obligation savings clause provision to forbid distribution to someone whom the donee powerholder owes an obligation of support. See Treas. Reg. §20.2041-1(c)(1)(B). It could trigger a gift if exercised so as to trigger the Delaware Tax Trap, discussed elsewhere herein. IRC §2514(d). Or, it could trigger a gift if the powerholder has a testamentary GPOA over the same asset, as discussed elsewhere herein, which is a good reason to add a collateral power held by a family friend or other nonadverse party.

[206] See IRC §642(c)(1) and Regs. The Supreme Court held in *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937) that "pursuant to the governing instrument" in IRC §642(c) plainly includes discretionary distributions, and need not be pursuant to a mandatory requirement. There is some uncertainty, however, from later narrower decisions from lower courts. Generally, you would be more secure in getting the §642(c) deduction the more direct, certain and specific the trust's charitable provision is, but a recent PLR followed the Supreme Court and permitted it for a discretionary distribution pursuant to a lifetime limited power of appointment. See discussion of such nuances in Chapter 6.08 of *Federal Income Taxation of Trusts, Estates and Beneficiaries* by Ascher, Ferguson, Freeland. Does a lifetime LPOA carry out *income*, since it is a power over specific *property*, not "income" or "principal"? Despite a tentative argument that appointing a specific asset might be a "specific gift or bequest" under the relation back doctrine and therefore not carry out DNI (Treas. Reg. §1.663(a)-1), other sections under that regulation indicate that even appointing a specific dollar amount or asset *does* carry out DNI under the same rules as any other trustee distribution to a beneficiary. This is the most logical interpretation, but I could find no specific authority. Regardless, a lifetime LPOA has enormous power and efficacy as a backstop to the trustee's spray power, if not as a complete replacement. If the LPOA powerholder is a mandatory income beneficiary, however, it may be deemed a gift of the lost income. *Estate of Regester*, 83 T.C. 1 (1984), though contrary is *Self v. United States*, 142 F. Supp. 939 (1956). If the powerholder also has a testamentary GPOA it would be considered a gift as well. Treas. Reg. §25.2514-1(b)(2). A deemed gift may not be a problem with large applicable exclusion amounts and annual exclusions, but why not allow for both if the spray power is properly circumscribed, or better, add a limited collateral power if there is a trusted friend/advisor to the family.

would suggest using separate trusts or subtrusts).[207] There are many scenarios where the family would be far better off with this spray capability, potentially lowering tax rates by 20% or more. Remember, the 0% rate for taxpayers in the bottom two tax brackets for LTCG/qualified dividends was "permanently" extended with ATRA as well.

Why QTIPs are (probably) terrible for tax shifting and what can be done (maybe)

Marital and QTIP trusts generally must require that the surviving spouse be the ONLY beneficiary entitled or eligible for income, so they are generally terrible vehicles for tax shifting. Or are they? Contrary to this commonly accepted wisdom, there is at least a good argument that a QTIP is able to give a surviving spouse a lifetime general power of appointment (aka 5/5 power). The tax code appears to disallow this unless it is only to appoint to the spouse, but two sections of treasury regulations appear contradictory, and there is a *PLR directly on point allowing a spouse to appoint 5% to herself or others*, with a rather compelling rationale to interpret the regulation in such a manner.[208] If the PLR and more importantly, such an interpretation of the regulation can be relied on, could this open up tax shifting opportunities?

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[207] IRA "see through trust" rules don't play well with most POAs and neither do QSSTs. ESBTs force higher rate taxation regardless of who the distributions are made to, so consider segregating those to separate trusts.

[208] The code seems to disallow: IRC §2056(b)(7)(B)(ii): "**(II)** no person has a power to appoint any part of the property to any person other than the surviving spouse.", but we can rely on treasury regulations that are looser: Treas. Reg. §20.2056(b)-7(d)(6): "The fact that property distributed to a surviving spouse may be transferred by the spouse to another person does not result in a failure to satisfy the requirement of section 2056(b)(7)(B)(ii)(II). However, if the surviving spouse is legally bound to transfer the distributed property to another person without full and adequate consideration in money or money's worth, the requirement of section 2056(b)(7)(B)(ii)(II) is not satisfied." How would a GPOA where the spouse can transfer to herself and/or others via gift fit the Regulation? See PLR 8943005 for an example of the IRS approving a QTIP with a lifetime 5/5 GPOA allowing the spouse to transfer to herself or others up to 5% of trust corpus annually: "[w]e believe the better reading of the legislative history would preclude a spousal power of appointment only where the exercise of the power would not be subject to transfer taxation; i.e., where the power is not a general power of appointment as defined in section 2514 of the Code. An interpretation requiring that a spouse must first take physical possession of the property prior to a transfer to a third party, would focus too much attention on the form of the transaction. It is sufficient that the exercise of the power by the spouse in favor of a third party would be subject to transfer taxation." Another regulation, however, seems to contradict the PLR and other Regulation above – Treas. Reg § 20.2056(b)-7(h), Example 4: "Power to distribute trust corpus to other beneficiaries. D's will established a trust providing that S is entitled to receive at least annually all the trust income. The trustee is given the power to use annually during S's lifetime $ 5,000 from the trust for the maintenance and support of S's minor child, C. Any such distribution does not necessarily relieve S of S's obligation to support and maintain C. S does not have a qualifying income interest for life in any portion of the trust because the bequest fails to satisfy the condition that no person have a power, other than a power the exercise of which takes effect only at or after S's death, to appoint any part of the property to any person other than S. The trust would also be nondeductible under section 2056(b)(7) if S, rather than the trustee, held the power to appoint a portion of the principal to C." How can the two seemingly contradictory regulations and PLR be reconciled? In the former, the spouse's 5%/$5000 power included the power to appoint to herself, in the latter, it did not. It is clear that no other party can have such a power. Treas. Reg. 20.2056(b)-7(h)

A typical 5/5 GPOA would be awkward and inefficient to shift the income taxation, since any such power would normally trigger §678(a), making such income or at least a portion of it taxable to the powerholder rather than the ultimate recipient. However, just as we might craft testamentary GPOAs in QTIPs for better basis increase for fractional shares of assets owned between QTIPs and surviving spouses, as discussed in Part II, we might be able to craft a 5/5 power in a QTIP that can more efficiently shift income.

What if the 5/5 power was a GPOA for estate/gift tax purposes, but not a "sole power" for §678(a) purposes? This may be the best of all worlds, because an unexercised 5/5 power ordinarily is an unholy nightmare to administer and track, because every lapse creates a changing fractional grantor trust.[209] For example, a power only exercisable with the consent of a non-adverse party would be a GPOA under §2514/§2041, but clearly be insufficient to trigger beneficiary-grantor trust status as to the powerholder under §678(a). Therefore, such a circumscribed power may be used to shift income, or more likely in a QTIP, capital gains. How would this work?

Back to our previous example: Barbara's **QTIP trust** has a 5/5 GPOA power requiring the consent of a non-adverse party to exercise. The trust corpus is $2 million and has ordinary income of $40,000 (equal to the trust's accounting income and distributable net income (DNI)), short-term capital gains of $30,000, and long-term capital gains of $70,000. The trustee does not allocate capital gains to trust principal. The trustee must distribute to Barbara all of the accounting income ($40,000). Barbara appoints (orders the trustee to distribute) $100,000, which is 5% of the corpus, to her children, who are in lower tax brackets, and the trustee or some other non-adverse party consents to the transfer. Because §678(a) is not triggered, ordinary Subchapter J (Parts A-D) principals apply. Provided that the trustee's "books, records, and tax returns" consistently treat such distributions as part of a distribution

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[209] See PLR 90344004 – "During each succeeding year in which A fails to exercise her [5/5] power, A will be treated as the owner of an increasing portion of corpus of T. For purposes of determining the increase in her deemed ownership her current withdrawal power for any particular year will cause an increase in the amount of corpus which she is treated as owning equal to the product of the amount which she could withdraw multiplied by a fraction the numerator of which is the portion of trust corpus which she is not already treated as owning and the denominator of which is the total of trust corpus from which the withdrawal could be made. Discretionary distributions made by the trustee from corpus will be treated as coming from both the portion of corpus which the beneficiary is treated as owning and from the portion which she is not treated as owning in the same ratio as the fraction mentioned above." Have fun with that calculation! This kind of §678(a) trust is the worst of all worlds.

to a beneficiary, as discussed above, the trustee must send a K-1 allocating $40,000 of interest and dividends to Barbara and K-1s for the $100,000 in capital gains to her children, who may well be in a 0% LTCG or 15% STCG tax bracket.[210] Even if the kiddie tax applied to use Barbara's highest income tax bracket, the 3.8% surtax is probably avoided, *since the kiddie tax only applies to income tax, not the Medicare surtax*.

Barbara, in the example above, would trigger a taxable gift for the $100,000 transferred – if she had three children and made no other gifts, and the annual exclusion were $15,000 at the time, this would use $55,000 of her applicable exclusion amount. However, QTIPs have some additional quirks: IRC §2519 treats *dispositions* of a QTIP as a transfer of the entire interest for gift tax purposes.[211] Neither the PLR nor the regulation mentioned §2519, nor has any case law developed on whether this could be a disposition. For planning purposes, it is probably prudent to assume that it could apply.

The chief question point in this planning is the reliability of the PLR. While the PLR is exactly on point, we cannot rely on PLRs for precedent. While we can rely on treasury regulations, the two regulations cited above conflict – they might be reconciled, but it's hard to be confident that the regulations clearly support the PLR enough for confident planning. Furthermore, §2519 is a huge question mark – many clients would accept triggering a taxable gift, which might even fly under an annual exclusion, but not want to trigger a gift tax on the entire QTIP. QTIP qualification is important even if the family does not need the marital deduction in the first to die's estate, because they may be relying on that to pull the trust back into the second to die's estate for a second basis increase.[212]

Why not just use a bypass (optimal basis increase) trust as noted above, which can get most of the advantages of a QTIP, with much more certain and more robust ongoing income tax advantages? Getting a PLR would probably only make sense for a wealthy family/ large QTIP to be worth the trouble. If you are inclined to add 5/5 powers in trusts (whether they are simply a power to appoint to self only, as many QTIPs do, or to self and others), at least consider the above §678(a) avoidance technique to avoid accounting nightmares.

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[210] Treas. Reg. §1.643(a)-3(b)(2)
[211] IRC §2519(a)
[212] IRC §2044 pulls any QTIP trust back into the surviving spouse's estate for inclusion, allowing §1014 step up

IRC § 642(c) - Notably, not only would IRC §642(c) offer "above the line" charitable deductions for the family from the trust, up to the entire gross income, not subject to 20%/30%/50% AGI limitations, but it offers a better deal for internationally minded clients with ties/interests in foreign countries – unlike IRC §170 for individuals, the trust income tax charitable deduction is expressly *not* limited to charities organized in the U.S..[213] Furthermore, unlike individuals, and even better than a 65 day election, a trustee can even elect to treat a contribution as made in a previous tax year, if the election is made by the due date of the income tax return and extensions, or even later if granted 9100 relief.[214]

Unlike charitable contributions from individuals, which do NOT affect MAGI or net investment income or an individual's 3.8% Medicare surtax exposure, the charitable contribution from a trust under §642(c) DOES reduce net investment income for purposes of the 3.8% surtax.[215] It can carry out capital gains allocated to corpus.[216]

Furthermore, there may be substantial state income tax benefits to §642(c) deductions, over a §170 individual tax deduction. Many states don't grant individuals a charitable deduction for state income tax purposes, or limit it, but states' trust tax regimes often start with the taxable income number from federal Form 1041, line 22, which is calculated *after* the §642(c) deduction.[217] Saving another 5-10% state income tax can be substantial state income tax savings, even if there is state-source income, like selling a business or real estate located in state.[218] More advantages may accrue if the trust's donation were large enough to exceed an individual's 20%/30%/50% AGI limitations, or if the individual beneficiary already had substantial carryforwards that would limit further use.

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[213] Treas. Reg. §1.642(c)-1(a)(2). The income tax deduction for individuals may be allowed to some foreign charities in some cases pursuant to treaty, such as Israel, Mexico or Canada – see p. 3 of IRS Pub 526, 597; US-Canada treaty, http://www.irs.gov/pub/irs-trty/canada.pdf

[214] IRC §642(c)(1): "If a charitable contribution is paid after the close of such taxable year and on or before the last day of the year following the close of such taxable year, then the trustee or administrator may elect to treat such contribution as paid during such taxable year." See also Treas. Reg. §1.642(c)-1(b) and PLR 2013-43002, which granted 9100 relief to permit election even after the due date w/extensions had passed.

[215] Treas. Prop. Reg. §1.1411-3(e)(2) and Treas. Prop. Reg. §1.1411-3(f) Ex. 2

[216] IRC §643(a)(3)(B)

[217] E.g. Ohio R.C. §5747.01(S), page 5 of instructions for Ohio Form IT-1041

[218] E.g., Both Ohio and New York would indirectly allow a charitable deduction to a non-grantor trust because they start with taxable income, yet Ohio does not recognize charitable deductions for individuals and New York may limit itemized deductions to individuals to 25% or 50% based on income. See www.tax.ohio.gov, http://www.tax.ny.gov/pdf/2012/inc/it201i_2012.pdf

Furthermore, regulations specifically permit that the governing instrument can control the character of the income distributed via §642(c) provided it "has economic effect independent of income tax consequences."[219] A mere ordering rule is insufficient, but we can accomplish advantageous results by creating limitations on lifetime limited powers of appointment (or spray powers) with such consequences.[220] For instance, if the trust limits the charities' potential distribution to gross income from net short-term capital gains, taxable interest and rents, it has the economic effect apart from income tax consequences because the amount that could be paid to the charity each year is dependent upon the amount of short term capital gains, taxable interest and rents the trust earns within that taxable year.[221] Therefore, in our example, Barbara's donor advised fund would not receive any long-term capital gains, qualified dividend or tax exempt income – the $20,000 would be limited to coming from the interest and short term capital gains. What a deal – the taxable beneficiaries can get the LTCG/QD eligible for 15%/0% brackets, while the charity gets the ordinary income otherwise taxed at up to 43.4%.

The IRS is surprisingly lenient when it comes to allocation of the charitable deduction when there are other non-charitable discretionary beneficiaries (i.e. not those entitled to "net income" or some variant). To return to our example of Barbara and her family bypass trust above, if the trustee (via spray or via Barbara or another party's use of a lifetime LPOA) had donated $140,000 to charity from the trust's gross income instead of $20,000 (assuming it was not limited to short term capital gains, interest and rents as postulated above), the result would be that Barbara or her family would have *no taxable income from the trust, despite receiving substantial distributions from it*.[222]

Furthermore, a distribution pursuant to a lifetime limited power of appointment may also qualify for the IRC §642(c) deduction. In a recent PLR, the trust had this clause:

> "[T]he Trustee shall distribute all or any portion of the trust estate, including both income and principal, as A may appoint, at any time and from time to time during A's

[219] Treas. Reg. §1.642(c)-3(b)(2)
[220] Treas. Reg. §1.642(c)-3(b)(2), Example 1 shows mere ordering rules to be insufficient
[221] Treas. Reg. §1.642(c)-3(b)(2) and Example 2, but proposed Regs under §1.1411-3 do not address whether this would equally apply for the surtax, see above. However, since most of the surtax follows subchapter J principals, there is a strong case that it should equally follow in this case to maximize the utility of the charitable deduction.
[222] Treas. Reg. §1.662(b)-2, Example 1, specifically paragraph (e)

lifetime or upon A's death, to any one or more organizations each of which is, at the time contemplated for an actual distribution to such organization, exempt from federal income taxation under § 501(a) as an organization described in § 501(c)(3) and also is described in al of §§ 170(c), 2055(a) and 2522(a)." (sic)

In this ruling, the IRS held that a distribution of gross income from the trust to one or more charitable organizations made pursuant to A's limited power of appointment will be made "pursuant to the terms of the governing instrument" as provided in §642(c)(1) and provided that the other requirements of §642(c) are satisfied, such distribution from the trust will qualify for the charitable contribution deduction under §642(c).[223]

One unique aspect to §642(c) was not discussed in the PLR, but merits attention. Most of the Subchapter J scheme taxing non-grantor trusts ignores tracing. For example, if the trust has $100,000 of income/DNI and distributes only Blackacre valued at $100,000 (and no assets traceable to income), *the trust will get a deduction and the beneficiary will get a K-1 for $100,000 anyway*. Such is not the case for §642(c) – the distribution **must** come from gross income, though it might come from income accumulated in a prior year.[224]

Another hurdle is that the use of §642(c) is limited for ongoing business income. IRC §681 limits §642(c)'s deduction if the income would be unrelated business taxable income (UBTI) if it were in the hands of a tax exempt entity.[225] Granting a §678(a) power to the charity in lieu would not be much help, since the net effect would result in the same payment of UBTI. This rule is important to remember when administering a shark-fin or other grantor CLAT funded with closely held businesses if the grantor dies during the term. Since §642(c) is unavailable for offsetting trust income from an S corp, LLC, LP or other pass through entity running an active business, this would be another logical curtailing of the scope of a lifetime power of appointment or spray power to charity (see various sample language examples in appendix).

In short, with all the above tax planning ideas, we have the *Holy Grail* of income tax planning available to widows/widowers with bypass trusts – the ability to trap income in trust

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[223] PLR 2012-25004

[224] There is a good argument that the "gross income" is simply a quantitative limitation rather than requirement for tracing, see *Federal Income Taxation of Fiduciaries and Beneficiaries*, §412.8.3. (CCH 2009), by Byrle Abbin. However, it is safest to assume in planning that sourcing is required.

[225] IRC §681(a), Treas. Reg. §1.642(c)-3(d) and (e)

if state tax savings can be had, to spray income to lower bracket beneficiaries, and get above the line charitable deductions (including in many cases, state tax reductions even when states otherwise limit or deny such deductions). It can even be tailored in many cases to apply to the most highly taxed income! See the comparison charts in the appendix for some quick summaries of ordinary trusts versus trusts with the above mentioned techniques embedded.

The above income tax shifting techniques require that someone die or make taxable gifts to non-grantor trusts. What about the other 100% of the population that prefers to have tax savings *before* they die? This brings us to the last section.

DINGs, NINGs, OINGs – Not just for STATE income tax advantage
(or, How to get a tax deduction for annual exclusion gifts to your kids)

Practitioners might consider not only embedding such strategies into bypass trusts, but in some cases might actively use such flexible provisions in other irrevocable non-grantor trusts during lifetime for better income tax planning. For example, the recently resurrected DING strategy used to avoid state income tax should include such clauses, and those with charitable intent who already have substantial charitable carryforwards may get more bang for the buck using a non-grantor CLT or non-qualifying non grantor trust with §642(c) provisions instead of a CRT/grantor CLT.[226]

Let's start with a typical DING example (NING, OING, etc if using **N**evada or **O**hio **I**ncomplete Gift **N**on-**G**rantor Trust). John and Mary are newly retired and well off, but not "rich". They no longer worry about estate tax. They have $1 million in real estate, $3 million in retirement plans, and $5 million in various stocks, bonds, and funds. They are wealthy enough, and generous enough, however, to make approximately $50,000 in annual exclusion gifts to their two children, who have young children themselves, and typically give about $30,000 annually to various charities through their donor advised fund at the Greater Cincinnati Foundation. They get no tax deduction for gifting to their children, no state income tax deduction for their gifts to charity, and their charitable deduction is somewhat "phased out" under the Pease limitations and cannot be used to offset the new 3.8% Medicare surtax. Let's say their taxable income is under $400,000, putting them in a 35%

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[226] See *The Art of Avoiding Ohio Income Tax Using Trusts*, by this author, May/June 2014 Ohio Probate Law Journal, and various other articles cited therein.

federal bracket, 5.41% Ohio, 15% capital gains, plus 3.8% surtax for net investment income other than IRA distributions, etc.

What if they moved $2 million of their investments to a DING type trust? Aside from better asset protection, let's flesh out how what happens for income tax under the above scenario if the same distributions are made from a DING trust instead of from John and Mary directly. Assume the $2 million in trust makes 2% taxable interest, 2% dividends, 1% capital gain (we'll ignore any unrealized capital gains/losses) = $40,000 interest, $40,000 dividends, $20,000 capital gain. Thus, at the most basic level, John and Mary have shifted $100,000 of taxable income from their personal 1040, to the 1041 of the trust.

When the trustee distributes the $80,000 to the children and charity, this completes the taxable gift, but the gift will qualify for the annual exclusion and/or charitable exclusion. The trust will get an above the line deduction, for federal (and usually state, as discussed above) tax purposes for the charitable contribution. If two children make $45,000 and $100,000 respectively, the K-1 for the qualified dividends distributed to them will be taxed at 0% and 15% respectively, not 18.8% (lowering the overall tax to the family on the $40,000 of qualified dividends from $7,520 to $3,000, plus more if the children live in a state with lower taxes than Ohio). The $10,000 of interest K-1'd to the children changes tax on that from 38.8% plus 5.41% Ohio to 15% plus approx. 4% state – cutting that tax by more than half as well. The charitable contribution is more advantageous as well – avoiding 3.8% Medicare and 5.41% Ohio tax on the $30,000, not to mention the Pease limitations, so there is another $3,000 or so benefit there.[227] Not to mention the fact that many taxpayers, even many higher income taxpayers, do not even itemize deductions.[228]

Would a family bother with a trust to get $10,000 tax savings annually? Perhaps. The higher the donor's bracket, the larger the gifts, the lower the donee's bracket = more savings. It's likely that only wealthier taxpayers in the top tax bracket would utilize this, so the savings in the above example would then be a bit higher, adding 4.6% to the arbitrage (35% -> 39.6%).

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[227] Pease limitations do not apply to non-grantor trusts and estates. IRC §68(e)

[228] According to one study of 2010 tax return data, of those in 15% bracket, only 37% itemize, of those in 25% bracket, only 65% itemize, of those in 33% bracket, only 70%, rising to 90% for those in top bracket. http://www.urban.org/uploadedpdf/1001486-Who-Itemizes-Deductions.pdf. If your client has paid off their mortgage, for example, and no longer pays local income tax (or perhaps no state), this becomes more likely.

IX. Conclusion - Pros and Cons of the Optimal Basis Increase and Tax Efficiency Trust

Much of the planning and techniques for the über-wealthy are unchanged after ATRA – the increased exclusion amounts merely turbocharge previous gifting techniques. The Optimal Basis Increase techniques herein won't help a wealthy couple with $100 million a bit, but they can be extremely valuable for sub-$10.5 million estates.

The *ongoing* trust income tax planning techniques discussed herein apply to all estate levels – even more so to wealthier families. After all, how many lower generation trust beneficiaries, even of wealthy families, always make over $400,000 or $450,000 in taxable income and are subject to the same tax rates as a non-grantor trust?[229] Even those rare wealthy families whose children/grandchildren/great-grandchildren all make over $450,000 in taxable income are often charitably inclined and should be considering the varied §642(c) techniques discussed herein.

For married clients with estates under approximately $10.5 million, the Optimal Basis and Income Tax Efficiency Trust offers the following advantages over an outright bequest, even where DSUE is successfully claimed: better asset protection from creditors, better divorce/remarriage protection, better protection from mismanagement, better sheltering of appreciation/growth from both federal and state estate and inheritance taxes, better planning in event of simultaneous or close death (potentially millions in savings for those estates where one spouse's estate is over $5.25 million), better use of GST exclusion, better incapacity planning, better Medicaid/VA/benefits planning, avoidance of step down in basis at second death and the ability to spray income to children/charities in lower brackets. The drawbacks are the same as with any trust planning: increased attorney fees (and potentially post-mortem, accounting/trustee fees) and complexity.

The Optimal Basis and Income Tax Efficiency Trust offers the following advantages over the traditional bypass trust: better step up in basis at second death, better compatibility with disclaimer planning, better ongoing income tax treatment for the trust and spouse overall and better income tax flexibility and charitable deduction treatment via spray provisions.

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[229] Thresholds for single/married filing jointly couples to incur the top 39.6% and 20% long-term capital gains and qualified dividends rates. See IRC §1 – those adjust for inflation. If someone has $100,000 of itemized deductions, that threshold may approximate $500,000/$550,000 AGI, since taxable income is calculated *after* the standard or itemized deductions.

The Optimal Basis and Income Tax Efficiency Trust offers the following advantages over a traditional QTIP (assuming amount under exclusion amount): better asset protection during the surviving spouse's life (for accounting income), better leverage of GST exclusion than reverse QTIP if income is reinvested, less complicated administration/compliance for retirement plan/IRA benefits,[230] better ability to augment or curtail powers of appointment, less chance of losing ported DSEU exclusion due to remarriage, better ongoing income tax treatment for the primary beneficiary, ability to spray income or capital gains to lower (or 0%) tax bracket beneficiaries, ability to gift without the IRC §2519 gift tax trap, ability to shelter from state estate/inheritance tax, ability to better avoid inadvertent discounting for fractional interests, no requirement to file (or chance to botch) Form 706 to make appropriate QTIP election, no prospect of the IRS using a Rev. Proc. 2001-38 argument to deny the effect of the election, and the prevention of a second step down in basis.

Just as importantly, although not extensively discussed herein, if the surviving spouse's estate, including the QTIP trust, increases over time above the survivor's Applicable Exclusion Amount (including portability), the bypass trust will almost certainly have saved more in estate taxes than the potential capital gains tax savings from getting new (presumably mostly increased) basis.[231] With many people expecting inflation to eventually increase with the recently expanded money supply (quantitative easing), realize that higher inflation over time exacerbates this extensively, since the locked in DSEU amount does **not** adjust for inflation. And remember, the first to die's family (QTIP) usually gets stuck with the tax apportionment – important for blended families.[232]

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[230] QTIPs require spousal net income access/payout from trust AND from IRA/QP owned by trust. Rev. Rul. 2006-26. This makes them "leakier" and wastes GST exemption if QTIP is GST exempt. This creates more problems administratively, since non-professional trustees do not understand this, especially if inflation reignites such that internal IRA accounting income becomes likelier to exceed RMDs – could an *Atkinson* style attack by the IRS based on improper administration retroactively destroy a QTIP just like a CRT?

[231] For illustrations of this savings if investment returns net 11% and the surviving spouse lives 15 or 30 more years, see Gassman, Crotty, Buschart & Moody *On the $28,000,000 Mistake: Underestimating the Value of a Bypass Trust and Overestimating the Value of Spousal Estate Tax Exclusion Portability,* Steve Leimberg's Estate Planning Newsletter #2061, concluding savings to be…$28 million. While I may have used different assumptions, the general thrust of the article/spreadsheets is in the right direction and makes a powerful point.

[232] Discussed in Part I, see IRC §2207A and your state equivalent, such as Ohio R.C. §2113.86(I)

There are some narrow situations in which a marital trust will generate better estate tax results than an OBIT.[233] There are also situations in which a marital trust will generate a better overall basis increase – consider two spouses who each have net $5 million estates and one survives by only two years, all assets mildly appreciate with inflation to $10.5 million total, and the spouse doesn't spray any income to lower bracket beneficiaries from the trust- the OBIT would not save any estate tax, not save any income tax, would only garner very minimal if any step up, whereas a QTIP (if portability elected and DSUE not lost) would not cost any estate tax and would garner slightly more step up in basis.

To craft a precise rule, you need to know asset mix, depreciation info, date of 2nd death, the beneficiary's distribution needs and whether a powerholder would spray income, tax rates/exclusions (including state), inflation, investment turnover, investment returns and more to make an accurate prediction. QTIPs used with portability have a sweet spot similar to the example above (total assets close to combined exclusion but little chance of eventual estate tax), but with similar or larger estates OBITs could save a lot more estate tax if the surviving spouse lives a significant time with returns outpacing inflation, and with smaller estates an OBIT can get the same step up AND avoid step down.

But basis increase (or lack of decrease) for the family at the surviving spouse's death is a *one-time event* – unless there is large estate tax this is probably not nearly as important as the *ongoing income tax efficiency* of the surviving spouse (and next generation's) trust. It is here that the Optimal Basis Increase and Income Tax Efficiency Trust offers the most flexibility, control and efficiency to optimize tax benefits long-term – all of the benefits of the traditional bypass trust but with avoidance of most of the drawbacks. Whereas a bypass/OBIT can be amended by decanting, non-judicial settlement, trust protector, trustee amendment, UTC provision, etc – a marital trust has to be extraordinarily careful NOT to allow any

[233] For the wealthy, a QTIP bequest with full DSUEA elected and reverse QTIP election would nearly always beat a standard bypass trust if the surviving spouse then immediately fully funded via gift an irrevocable grantor trust (or released a portion of the QTIP to trigger IRC §2519). This could then exploit installment sales, swaps, etc. Using grantor trusts funded via gift after the first death enable the use of pre-estate tax dollars to pay the income tax burden of the grantor trust. Most wealthy couples will have already funded irrevocable grantor trusts during their lifetimes, but those who haven't should strongly consider that technique (a typical OBIT could, of course, be converted to a QTIP if powers disclaimed/released and timely election made – see Clayton QTIP discussion p. 9)

amendments, however well meaning, else the marital deduction will be denied.[234] We have to tread carefully with post mortem amendments to marital (or charitable) trusts.

As discussed, using the Delaware Tax Trap to maximize basis in some circumstances is safer and can be more targeted than using a formula GPOA, but both can probably be used effectively (especially if no cap is needed for smaller estates). However, the best of all worlds would be to have some variant of state law that clearly allows triggering the Delaware Tax Trap by creating successive *limited* powers of appointment, as the draft law in the Appendix attempts to move forward.

There will be certain situations in which some of these techniques should not be used. For instance, the common situation in which someone wants to protect an inheritance for children from a prior marriage and severely curtail the spouse's interest – but even then many taxpayers will prefer variations of some of these techniques.[235]

Many taxpayers have been reticent to pay attorneys for needed amendments to planning due to "tax volatility fatigue" and frustration with Congress. The pitfalls and techniques discussed in this article, coupled with apparent permanency, should give substantial financial incentives for clients to revisit their old estate plan. These techniques are not available to "do it yourselfers" or general practitioners – there are no off-the-shelf, Nolo Press, Trusts-R-Us or other online form books for any of this. However, any attorney specializing in estate planning can easily adapt these ideas to provide tremendous value to their clients.

[234] This is why most decanting statutes specifically exclude marital trusts and trust protector/amendment provisions had better do the same – see PLR 9525002 for a cautionary tale of good intentions gone awry. Also, note, protector/amendment provisions that permit the addition or modification of a GPOA should proscribe the power from applying to those categories of assets discussed in Part III (capped to AEA and only those assets benefitting from §1014), otherwise there is an argument that the potential powerholder may have a GPOA over the entire trust merely by virtue of a non-adverse party being able to add a GPOA per IRC §2041(b)(1)(C)

[235] e.g., would giving the surviving spouse the power to appoint equally to a trust for settlor's children from prior marriage which grants them a presently exercisable general power of appointment be all that different from a default clause that pays to them outright? Would a spouse really appoint to creditors to spite remaindermen and would the chosen non-adverse party conceivably consent to that? Remember that QTIPs tax apportionment differs than tax apportionment with a GPOA, which may matter for federal, or possibly state estate taxable estates.

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Recent Speaking Engagements and Published Articles:

- Author*, Increasing Trust Income Tax Efficiency After ATRA with Better Bypass Trust Options,* Probate Law Journal of Ohio, Sept./Oct. 2013, Volume 24, Issue 1
- *Speaker, 2013,* Ohio State Bar Association Annual Conference on Wealth Transfer Planning*, Asset Protection and the Ohio Legacy Trust, Optimal Basis Increase Planning*
- Author*, The Optimal Basis Increase Trust,* Leimberg Information Services*, March 2013*
- Author, *Optimizing Trusts to Avoid the New Medicare Surtax,* Trusts and Estates, Dec. 2012
- Speaker, 2012 American Bar Assn Tax Section Meeting: *Estate Planning for Large Retirement Plans*
- Speaker, 2011 Purposeful Planning Institute and 2011 SFSP Annual Tax Symposium, *Exploiting Asset Protection and Tax Planning Opportunities after the 2010 Tax Act*
- Speaker, 2010 Ohio Wealth Counsel CLE: *Advanced Asset Protection Planning*
- Speaker, 2009 Dayton Bar Association CLE, *Protecting Trust Assets from Tax Liens*
- Author, *Trusteed IRAs: An Elegant Estate Planning Option*, September 2009 Trusts and Estates
- Co-Author, *Ensuring the Stretch*, July/August 2007 issue of Journal of Retirement Planning
- Author, *Using Separate or Standalone Trusts as Qualified Plan/IRA Beneficiaries*, Sept/Oct 2007 issue of Journal of Retirement Planning

26 U.S.C. §2041 – Powers of Appointment

(how powers of appointment are included in gross estate, sections ***bold/italicized*** are sections discussed by author, [bracketed comments inserted by author])

(a) In general
The value of the gross estate shall include the value of all property—
(1) Powers of appointment created on or before October 21, 1942
[**omitted** – but important if you have an old trust]
(2) Powers created after October 21, 1942
To the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive. For purposes of this paragraph (2), the power of appointment shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a 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 date of the decedent's death notice has been given or the power has been exercised.
(3) Creation of another power in certain cases **[aka the Delaware Tax Trap]**
To the extent of any property with respect to which the decedent—
(A) by will, or
(B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent's gross estate under section 2035, 2036, or 2037,
exercises a power of appointment created after October 21, 1942, 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.
(b) Definitions
For purposes of subsection (a)—
(1) General power of appointment
The term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that—
(A) A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.
(B) A power of appointment created on or before October 21, 1942, which is exercisable by the decedent only in conjunction with another person shall not be deemed a general power of appointment.
(C) ***In the case of a power of appointment created after October 21, 1942, which is exercisable by the decedent only in conjunction with another person—***
(i) If the power is not exercisable by the decedent except in conjunction with the creator of the power—such power shall not be deemed a general power of appointment.
(ii) ***If the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent—such power shall not be deemed a general power of appointment.*** For the purposes of this clause a person who, after the death of the decedent, may be possessed of a power of appointment (with respect to the property subject to the decedent's power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the decedent's power.
(iii) If (after the application of clauses (i) and (ii)) the power is a general power of appointment and is exercisable in favor of such other person—such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of such persons (including the decedent) in favor of whom such power is exercisable.
For purposes of clauses (ii) and (iii), a power shall be deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate.
(2) Lapse of power
The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The preceding sentence shall apply with respect to the **lapse** of powers during any calendar year **only to the extent** that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:
(A) $5,000, or
(B) **5 percent** of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.

Glossary of Terms[236]

"Power of appointment" – a power that enables the donee of the power (powerholder), acting in a non-fiduciary capacity, to designate recipients of beneficial ownership interests in the appointive property.

"Donor" – the person who created the power of appointment.

"Donee" – the person on whom the power is conferred and who may exercise the power. However, I prefer to use the term "Powerholder" to avoid confusion.

"Permissible appointees" – the persons for whom the power may be exercised to benefit

"Appointee" – a person (or entity/trust) to whom an appointment has been made.

"Taker in default"- person(s) who would receive property if power is not exercised.

"General Power of Appointment" ("GPOA") – a power exercisable in favor of the donee (powerholder), the powerholder's estate, the powerholder's creditors or the powerholder's estate. For tax definition, see IRC §2041/2514.

"Limited, or Nongeneral Power of Appointment" ("LPOA") – any power that is not a general power of appointment. Some also use the term "special power of appointment" – I will use "limited power of appointment" throughout this outline.

"Presently exercisable general power of appointment" – sometimes referred to as a PEG power, is a power that permits the powerholder to exercise it with effect during their lifetime, as opposed to a testamentary power, exercisable and effective only at death.

"Testamentary LPOA or GPOA" – a power that is exercisable only at death, whether by will, trust or other writing (often referred to as by "deed", even though not recorded)

"Power Trust" – a trust in which the settlor grants a lifetime limited power of appointment in someone other than themselves, and the permissible appointees of the power include the settlor. This is not a universally accepted term, but I could not think of a better acronym or abbreviation for it. See other asset protection CLE materials by author on this topic.

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[236] Many paraphrased from *Restatement of Property, Donative Transfers*, 2nd and 3d – see §17.1 et seq.

Appendix of Sample Clauses, Letters, Charts, Infographics

"With regard to excellence, it is not enough to know, but we must try to have and use it."

- **Aristotle**, *Nichomachean Ethics*

Charts

[Note, throughout the sample language you will note my preference for single rather than joint trusts. For those in community property states or who otherwise use joint trusts, some language might be adapted for joint trusts.]

Sample Language for Formula GPOA for Bypass (Family, Credit Shelter) Trust

Subject to the remaining provisions of this Section, my spouse has the testamentary power to appoint a certain portion of assets, be they allocable to principal or undistributed income, remaining in the Family Trust at my spouse's death. This power shall apply differently or not at all to different assets. The potentially appointive assets shall be constrained and limited as follows:

1) **General Power of Appointment** – My spouse may appoint certain assets of the Family Trust to my spouse's creditors [you could alternatively say "my spouse's probate estate" to the same effect, but my preference would be to say creditors to better exclude the new wife/husband as potential beneficiary, which many clients would want] or to my descendants in such amounts and subject to such terms, including trusts, as my spouse directs. [alternatively, this may be broader and include other uncles, cousins, friends, charities, etc] [it is **highly recommended** that you require a **non-adverse party consent**, which might apply only to appointment to creditors, or, some clients may also wish it to apply to other non-equal appointments as well – e.g. "**my spouse may only appoint to his or her creditors with the consent of ____________ and/or ___________"** (these persons or entities cannot be a beneficiary or "adverse party" – an independent trust company for instance, may be non-adverse), or "Any appointment that is other than equal to my children or to trusts for my children, per stirpes, may only be made with the consent of ______________]". [Alternate #1 definition of potentially appointive assets] The assets subject to this general power of appointment shall be all assets of the Family Trust, **excluding**:

   (i) all property that constitutes *income in respect of a decedent* (IRD), except employer securities previously received in a lump sum distribution from a qualified plan containing net unrealized appreciation (NUA) that would also be IRD pursuant to IRC §402 and §1014(c). Only such employer securities that have unrealized gains post-lump sum distribution are eligible to be an appointive asset pursuant to this paragraph, those without unrealized gains post-distribution are not eligible;

   (ii) Roth IRA accounts or Roth variants of other retirement plans such as 403(b), 457(b), or 401(k) plan accounts;

   (iii) 529 Plan Accounts or Coverdell Education Savings Accounts (ESAs);

   (iv) all 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 spouse's death;

   (v) all life insurance policy or annuity death benefit proceeds owned by and payable to the trust as a result of my spouse's death.

After eliminating the above described assets from the appointive assets subject to this general power of appointment, if such remaining assets' inclusion in my spouse's taxable estate for federal and/or state estate tax purposes would not increase my spouse's federal or state estate or generation skipping transfer tax liability, **assuming any marital or charitable deduction is denied to my spouse's estate**, the general power described above shall apply to all remaining assets of the Family Trust.

[Alternate version of above without the charitable/marital reduction] - After eliminating the above described assets from the appointive assets subject to this general power of appointment, if such remaining assets' inclusion in my spouse's taxable estate for federal and/or state estate tax purposes would not increase my spouse's federal or state estate or generation skipping transfer tax liability, the general power described above shall apply to all remaining assets of the Family Trust]

[Rather than starting with all assets and then *excluding* certain assets, as above, it is probably preferable and simpler to do the opposite – start with no assets and then define the potential assets eligible to be appointive assets, since new tax categories of assets may be created in the future, or frankly, I may have just omitted one that should have been excluded. Here is a potentially better variation:

[Alternate #2 definition of potentially appointive assets] The assets potentially subject to this general power of appointment shall only be those assets of the Family Trust whose tax basis would increase in value pursuant to IRC §1014 if included in the powerholder's estate.

However, should such inclusion otherwise result in federal or state estate or generation skipping transfer tax liability (even if any marital/charitable deduction were also denied), the appointive assets subject to this general power of appointment shall be further limited, and apply or not apply to each remaining asset of the trust not previously excluded as a potential appointive asset above in the following order.

The power shall apply to the asset with the largest percentage of difference between fair market value at the time of the powerholder's death and the cost basis immediately prior to the powerholder's death first, cascading in turn to each subsequent asset with the next largest percentage difference between fair market value and cost basis (e.g. an asset with basis of $10, FMV of $100 would have a "percentage of difference" of 90/100, or 90%).

[Here is a clause that would give a preference to depreciable property and collectibles, which would generally be more valuable for beneficiaries – I did not differentiate between 5 year, 27.5 year, 39 year property, etc, someone more detailed than I might craft a version that does:

[Alternate] In ordering these trust assets, and purely for the purpose of ordering which assets are appointive assets, depreciable assets shall be deemed to have a percentage of difference 50% higher and collectible assets 30% higher. To illustrate, if the trust owns a building with a basis of $100,000 and FMV DOD $200,000, stock with a basis of $90,000 and FMV $200,000 and art with a basis of $110,000 and FMV $200,000, the percentage of difference for purposes of this paragraph shall be (50% times 1.5) 75%, 55% and (45%

times 1.3) 58.5% respectively, thus the power of appointment shall apply first to the building, then to the artwork and finally to the stock.] For purposes of this paragraph, entities taxed as a partnership that hold depreciable assets shall be considered depreciable assets, regardless of whether an election is made under IRC §754.

[Alternatively, and this gets even more complex, you could try something that tries to be even more targeted to the tax effect by looking to the tax effect upon the trustee or even the beneficiaries (more accurate, but much more complicated).

[Alternate] The power shall first apply to the asset which, if the basis were increased to the powerholder's date of death value, would reduce the hypothetical federal [I would omit state for ease of calculation, but some might want to include it] income tax, including the net investment income Medicare surtax, the most as a percentage of overall value if all of the potentially appointable assets of this trust were sold immediately after my spouse's death. The calculation of such hypothetical federal income tax which would be recognized shall be determined under the highest bracket without consideration of any other income tax deductions, credits, exemptions, loss carry forwards or carry backs, which would otherwise be recognized on the filing of a fiduciary income tax return. For illustration, assume the trust had an IRA, an annuity, cash, stock with a basis of $100,000, FMV $90,000, a building with basis $100,000, FMV $200,000 ($70,000 basis reduced due to depreciation), P&G stock basis $120,000, FMV $230,000 and artwork with basis $130,000, FMV $220,000. The first four categories of assets would be disregarded as not even potentially appointable. The trustee would calculate the hypothetical tax on the remaining three assets as follows: building ($60,000 times 28.8% (25% depreciation recapture + surtax) plus $40,000 times 23.8% = $17,280 + $9,520= **$26,800** hypothetical tax; P&G stock $110,000 times 23.8% (20% LTCG rate plus 3.8% surtax = **$26,180;** artwork ($90,000 times 31.8% (28% collectibles rate plus surtax) = **$28,620.** These hypothetical tax numbers would then be divided by the FMV to determine which asset would hypothetically benefit the most from a basis increase: $26,800/$200,000 = **13.4%**; $26,180/$230,000 = **11.38%**; $28,620/$220,000 = **13.01%.** Accordingly, the power shall apply to the building first, then the artwork, then the stock.]

[note: my own preference would be to use some sort of simple artificial grossing up of the difference for depreciable property (less so collectibles), because unlike other assets, added basis to depreciable property usually benefits taxpayers whether the property is sold or not.]

Once an asset's (or group of assets') inclusion as appointive assets would otherwise cause an increase in my spouse's federal or state estate tax liability [assuming the marital or charitable deduction were denied the estate], the power to appoint them shall be limited to that fraction or percentage that would not cause any estate tax liability. Upon reaching this limit, all other assets are excluded from this general power of appointment [and shall be subject to the limited power of appointment described in paragraph 2 below].

Property with different cost basis for different lots or purchases shall be considered completely separate property for this purpose (e.g. 100 shares of ABC stock bought at

$350/sh shall be considered different from 100 shares bought at $500/sh a year later), and may be divided or fractionalized accordingly.

Property that is employer securities received as a lump sum distribution from a retirement plan with net unrealized appreciation shall consider said net unrealized appreciation for this purpose (e.g. 1000 shares of P&G stock with a tax basis of $50,000, net unrealized appreciation of $20,000 and fair market value of $85,000 shall consider the basis to be $70,000 for purposes of application of this paragraph. If the stock's value were equal to or less than $70,000, it would accordingly not be an appointive asset subject to this GPOA).

For purposes of illustrating the intent of this Paragraph 1, if $50,000 could be added to my spouse's estate prior to application of this Paragraph 1 without causing state or federal estate or generation skipping transfer tax, and the asset with the largest percentage difference between cost basis and fair market value is 100 shares of ABC stock with a basis of $35,000 and fair market value of $100,000, then this general power of appointment shall extend to only 50 shares from that lot of stock.

A material purpose of this paragraph 1 is to grant my spouse a general power of appointment as defined under IRC §2041 limited in such a way as to maximize the income tax basis increase under IRC §1014 of the property held in the Family Trust without increasing my spouse's federal or state estate or generation skipping transfer tax, so as to provide the maximum tax benefit to our ultimate beneficiaries. This trust may accordingly be amended or decanted pursuant to applicable state law [or, reference a trust protector or independent trustee amendment clause if there is one already in the trust to permit amendments] to comply with this intended purpose should:

a) IRC §1014, IRC §2041 or other applicable income and transfer tax law be materially changed;

b) the state, federal or foreign estate or inheritance tax applicable to my spouse's estate be materially changed;

c) my spouse's estate appear likely to be insolvent and my spouse resides in a state which does not protect assets subject to a testamentary general power of appointment from a decedent's or decedent's estate's creditors;

d) an improved formula yield superior tax results for the beneficiaries; or

e) any other situation arise which would frustrate the intention of this paragraph.[237]

2) **Limited Power of Appointment** **[note, there is no tax need for an LPOA, it is entirely dependent on whether a settlor wants to grant flexibility of distribution]** - My spouse may appoint all other assets not subject to the general power of appointment in paragraph 1 above or the exclusion in paragraph 3 below to my descendants or to any trust primarily therefore, which shall specifically exclude my spouse, my spouse's estate, my spouse's creditors, or creditors of my spouse's estate. [This may be in such amounts or shares as my

[237] Lest a practitioner be worried that the IRS could make some crazy argument that a power cannot be changed from limited to general or vice versa under state law, the Restatement of Property is clear that a power's status as limited or general depends on the actual situation at any given time. *See* Rest. Prop., Third, § 17.3, comment d.

spouse shall determine, including all to one descendant to the exclusion of all others]. [Alternatively, many clients may want to make this much more specific (e.g. descendants only unless all predecease, or to descendants and/or trusts therefore equally), or even require a non-adverse party's consent, for non-tax reasons (to prevent disinheriting one child, for example) Further note – if IRA/Qualified Plan assets were payable to the trust, and there is no conduit provision, then further limitations are recommended – see separate outline/checklist on IRA and see-through trust issues.

3) **Proceeds of life insurance held by the trust insuring the life of my spouse –** My spouse shall not, however, have any power of appointment (limited or general) over any proceeds of life insurance owned by the trust and payable to the trust that insures the life of my spouse [I am skeptical that this is needed at all – a *testamentary* POA over the trust assets may not be an incident of ownership pursuant to IRC §2042 of a policy owned by the trust. And, few bypass trusts would own life insurance on the surviving spouse – avoiding IRC §2042 would preclude the surviving spouse acting as trustee as well. However, I included this in an abundance of caution pending research. Also, you could have a scenario where 2042 inclusion would be moot (ie not cause estate tax), a nuance which is not accounted for in this paragraph. Theoretically, someone may want their spouse to be able to appoint life insurance proceeds as well if no additional tax is caused]

Form and Method of Exercise of Any Power of Appointment -

My spouse has the exclusive right to exercise the above limited and general powers of appointment. [However, an agent for my spouse under a Power of Attorney or a court appointed guardian may also exercise the testamentary power of appointment under the same conditions as noted above.] The above powers may be exercised by specific reference to this power of appointment in a Will, revocable living trust, or other written instrument that is witnessed or notarized. [Many attorneys limit this only to wills, such as "may be exercised only by a will specifically referring to this power of appointment"]. Should multiple attempts to exercise conflict, the last executed document shall control. The trustee may rely on a power of appointment exercised via Will not yet admitted to probate, but the trustee may in its discretion insist that any Will containing such exercise be admitted to probate or filed for public record. In determining whether a testamentary power of appointment has or has not been exercised, the trustee may rely on its knowledge of any exercise or lack thereof and proceed accordingly without liability (except for actions taken in bad faith), in the absence of actual knowledge to the contrary made known within three months after the powerholder's death.[238]

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[238] States may also have indemnification statutes to enable trustees to move on if there is no will filed/knowledge of exercise – see, e.g. Washington statute RCW 11.95.060(2), some language from which you may consider parroting in your document: "Unless the person holding the property subject to the power has within six months after the holder's death received written notice that the powerholder's last will has been admitted to probate or an adjudication of testacy has been entered with respect to the powerholder's last will in some jurisdiction, the person may, until the time the notice is received, transfer the property subject to appointment on the basis that the power has not been effectively exercised. The person holding the property shall not incur liability to anyone for transfers so made if the person had no knowledge that the power had been

Unless appointive assets are otherwise curtailed, such appointments may be in cash or in kind and may direct specific property to any one or more of the permitted objects of the power, either in trust, or by creating life estates or other restrictions or conditions for any one or more permitted objects of the power and remainders to other permitted objects.

Conditional expansion of permissible appointees if appointments made in further trust primarily for permitted appointees [note, something like this paragraph should be considered if there is not a broad class of appointees, for instance, only to descendants under Paragraph 2 or only to descendants or creditor in Paragraph 1]. If my spouse makes appointment in trust for any of the permitted appointees as noted above, such that a permitted appointee or appointees are the primary beneficiary or beneficiaries during their lifetimes, then a permitted appointee may in turn be given a broad lifetime or testamentary, limited or general power of appointment, permitted appointees of which may include charities, creditors or other parties, even if such parties were not in the original class of permitted appointees. In addition, the remaindermen need not be in the initial class of permissible appointees. For example, my spouse may appoint to a trust primarily for my child for my child's lifetime, granting my child a broad lifetime limited power of appointment and/or testamentary powers of appointment similar to this section, and the remainder beneficiary upon my child's death may be a charity or spouse of a child. [strongly consider using something like this unless someone demands that grandchildren, for example, be fully vested, not subject to divestment by a child's exercise of a POA or otherwise (in that case, you might modify this further). This clause allows further LPOA/GPOA OBIT language to harvest basis for the next generation, allows further spray capabilities via LLPOA for better income tax planning, better asset protection if the primary beneficiary is frozen out, etc. The Restatement of Property, 3d, Donative Transfers, §19.2 is clear that appointments to non-permitted appointees may be voided as a fraud upon the power, but what if later remaindermen, spray beneficiaries, etc are not among initially permitted appointees? In most states, but not all, a POA that can distribute outright or to a permissive appointee in trust can also grant that same appointee a broad POA in the appointive trust under the theory that the beneficiary could have been granted outright ownership. E.g. Washington statute RCW 11.95.060. However, unless you know for certain your client's residency and state law on this issue, it safest to expressly permit it. See e.g., 25 Del. Code 505, which is mostly positive, but still has flaws re LPOAs - http://codes.lp.findlaw.com/decode/25/5/505]. Here is a citation that will shock readers, and why you should consider something along the lines of above, or a variation: "An appointment by the donee [powerholder] of a special power to one who is not a member of the class is ineffective, at least to that extent. Thus, a power to appoint among the testator's children or their heirs upon such terms and conditions as the donee [powerholder] may direct

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exercised and had made a reasonable effort to determine if the power had been exercised. A testamentary residuary clause which does not manifest an intent to exercise a power is not deemed the exercise of a testamentary power." You might add an example of intent – it is not uncommon for a will clause to read "I hereby appoint any and all assets over which I have a power of appointment to…." – this inevitably leads to litigation as to whether this is specific enough to trigger a POA – states/courts may differ. Ohio has a statute requiring a POA appointment by will to be specific, but has no parallel statute regarding trusts/deeds.

does not authorize an appointment to the children for life, with the remainder to their children."[239]

Any assets not so appointed under paragraph 1 or 2 above shall pass according to the takers in default of appointment clause below. All values determined for purposes of this Section shall be as finally determined for federal estate tax purposes as of my spouse's death. My trustee may rely on values obtained from my spouse's executor (or trustee, if no executor is appointed) used for any state or federal estate tax filing. Should assets later be determined upon audit or amended return to be higher or lower than initially determined, the trustee is absolved from liability for having transferred items to any impermissible appointee via General Power of Appointment in reliance on the above data. However, any impermissible appointees shall hold such funds in constructive trust for those appointees of any limited power of appointment or takers in default who would have otherwise received the assets.

In Pari Materia – In the event that my surviving spouse is a beneficiary of another trust with a similar formula power of appointment provision, whether with myself or another party as settlor, this section shall be read together with the like section in the other trust as if the two trusts subject to the formula general power of appointment were one trust so that under no circumstance could such formulas ignore the other so as to cause my spouse's total appointive assets under multiple general powers of appointment to create estate inclusion resulting in state or federal estate or generation skipping transfer tax.

Coordination with and Reliance upon Powerholder's Executor

The trustee shall rely on a written statement, which may be in the form of a draft federal or state estate tax return, from the personal representative (executor) of the powerholder's estate as to the size of the powerholder's taxable estate (determined, as mentioned above, without regard to any marital or charitable deduction), including available applicable exclusion amount. If no personal representative is appointed, such a statement may be obtained from the trustee of the powerholder's living trust, or other party considered a statutory executor under IRC §2203.

Note #1 – GST/Dynastic - this language may be adapted to apply to non-spousal powerholders, of course, and some of this may be adapted and incorporated into the exercising instrument wherever a limited power of appointment is used to trigger the Delaware Tax Trap (see later sample clauses). The *above formula may be adapted to apply to the extent of available GST exclusion* rather than simply to the extent that any appointment does not cause GST *tax*. See the next sample clause for an alternate version, with additional

[239] *Scott and Ascher on Trusts*, 5th Edition, ¶ 3.1.2 Exercise of Power of Appointment, citing *In re Dohrman (Matter of Fiske*), 195 Misc. 1017, a case where a widow's husband had granted her the power to appoint in trust for children upon her own "terms and conditions", but she appointed in trust for children with their issue as vested remainder. The children objected, claiming that the power to leave to them in trust was valid, but that the vesting of the remainder in their descendants was invalid because their issue were not permissible appointees – the court agreed with the children, and the children took the assets subject to the life terms, but had free reign over the remainder interest to leave to spouse, charity, whomever at their deaths– presumably the remainder would thus be in their estates. Surprise! I doubt most practitioners would catch the import of a clause similar to this case.

commentary and pros and cons of that variation.

Note #2 – Alternate Valuation Date - AVD is not addressed above. In theory, an AVD could be addressed to tweak basis further in rare situations. AVD is only available when the estate tax is reduced. I did not address this to simplify administration (and my drafting :-) – to address AVD would require delaying determination of the value of the power of appointment by six months and potentially complicate matters. I may address a variation of this in future iterations or presentations. Example: Jane, a surviving spouse and beneficiary of an OBIT established by her late husband, dies with a $6 million estate of her own (thus, she has no AEA and therefore no GPOA over the OBIT) – but the market crashes and 6 months later those same assets are $4.5 million. The OBIT may therefore exploit $0.75 million of Jane's remaining applicable exclusion amount (assuming no DSUEA, $5.25 AEA), but the language above uses DOD values only, which may still have some benefit, but would not be optimal. Can a GPOA simply be delayed (probably, see page 28 and Treas. Reg §20.2041-3(b)), and can it be applied to assets based on a value 6 months later? Probably - I welcome any comments or suggestions here.

Note #3 – Indemnifying trustee for administration of assets between the date of death and determination of exercise of power of appointment. When the surviving spouse/powerholder dies, it may be months before the trustee knows the existence of the POA's exercise, much less the exact value of the surviving spouse's net estate (and the value of any marital/charitable deductions). If the GPOA applies to a piece of real estate, and the trustee in good faith sells the real estate after death, then the GPOA should probably apply to cash traced to the sale.

Note #4 – There is no accounting for debts/liens/encumbrances in the above language. Most bypass trusts are not leveraged, but you may have residence with a mortgage, a margin account, or maybe even intra-family loans to the bypass. Future versions of this language may add provisions to account for "net value after debt" for those situations, which are not an issue when someone has a POA over an entire trust. It should not be an issue in the above language if a lien is tied to an asset. For example, if there is $1 million available exclusion and the most appreciated asset is a $1.5 million building with a $500,000 lien, the entire building may still be appointed, subject to the accompanying debt, because the net amount transferred pursuant to the GPOA would be $1 million. I don't think additional language is needed to handle that. However, debt situations could be problematic when the debt is not associated with or a lien against a particular asset.

None of this language is warrantied or may be relied on in any way – nor is it legal advice that can be relied upon for penalty protection. Use at your own risk. Any constructive criticism appreciated.

Teleconference on The Optimal Basis Increase Trust, or June 13, 2013 Ohio State Bar Association Estate Planning Conference on Wealth Transfer, or other presentation by this author are free to copy and adapt any sample clauses for their personal law practice, without need for attribution. For any other use, please contact author at edwinmorrow@msn.com or edwin_p_morrow@keybank.com. As a courtesy, if variations are used or improved upon, please send any adapted language to me for feedback. Ideally, I would like to note any suggested improvements and give credit (or anonymously, if someone prefers) for suggestions or improvements in any future presentations.
Thanks to Ohio attorney Brian Layman (www.laymandatri.com) for provided substantial constructive feedback on this clause, and Ohio attorney Andy Richner for providing substantial feedback on Part II of this article and California attorney Terence Nunan for sharing his article and sample formula GPOA clauses.

Sample Language for Formula GPOA for Bypass (Family, Credit Shelter) Trust –

Alternate version tracking available GST exclusion rather than available AEA (to maximize basis increase ONLY to the extent of available GST exclusion)

Subject to the remaining provisions of this Section, my spouse has the testamentary power to appoint a certain portion of assets remaining in the Family Trust at my spouse's death. This power shall apply differently or not at all to different assets. The potentially appointive assets shall be constrained and limited as follows:

1) **General Power of Appointment** – My spouse may appoint certain assets of the Family Trust to my spouse's creditors or to my descendants in such amounts and subject to such terms, including trusts, as my spouse directs. The assets potentially subject to this general power of appointment shall only include assets of the Family Trust whose tax basis would increase in value pursuant to IRC §1014 if included in the powerholder's estate.

However, should such inclusion otherwise result in federal or state estate or generation skipping transfer tax liability (even if any marital/charitable deduction were also denied), *or exceed my spouse's available generation skipping transfer tax exemption such that an appointment of potentially appointive assets as defined above could cause an GST inclusion ratio of an appointive trust to increase*, the appointive assets subject to this general power of appointment shall be further limited, and apply or not apply to each remaining asset of the trust not previously excluded as a potential appointive asset above in the following order. Whether my spouse actually appoints to a trust that would benefit from GST exclusion is completely irrelevant to determining whether a general power of appointment applies under this paragraph.

INSERT AN ORDERING PARAGRAPH HERE, SEE SAMPLES IN PRIOR SAMPLE CLAUSE

Once an asset's (or group of assets') inclusion as appointive assets would otherwise cause an increase in my spouse's federal or state estate tax liability [assuming the marital or charitable deduction were denied the estate], *or go beyond my spouse's available GST exemption*, the power to appoint them shall be limited to that fraction or percentage that would not cause any estate tax liability *or go beyond any available GST exclusion*. Upon reaching this limit, all other assets are excluded from this general power of appointment.

Note – Often, one would have the same or greater GST exclusion as estate/gift exclusion, but not always, especially with the new DSUE/portability – also consider someone who used annual exclusion Crummey gifts and allocated GST exclusion. Thus, *the above formula is adapted to apply to the extent of available GST exclusion* rather than simply to the extent that any appointment does not cause *GST tax*. I did not address this in the first version because most couples and their children would want the second basis step up even if it caused portions of assets to go to a GST *non-exempt* trust, but I could imagine scenarios where a client may prefer to preserve the maximum GST exemption more than garner a second step up in basis (e.g. child is wealthy themselves, terminally ill, etc). For example, surviving spouse has $6 million AEA ($5.25 Million BEA plus $0.75 million DSUE) and $4.5 million GST exclusion

($5.25 million GST minus $0.75 million due to GST allocations to Crummey trusts) and a $3 million net estate – the formula above could be adapted to cap the GPOA at $1.5 million in lieu of $3 million, which would lose a basis increase over $1.5 million, but allow $1.5 million in the bypass to continue to be GST exempt (if it is a dynasty trust).

Which is preferred? If the children are only moderately wealthy, or wealthy and charitably inclined, or spendthrifts, they would not get any benefit from the additional trust funds being exempt from their estate via GST exemption, or perhaps they can easily use Crummey/IGTs/GRATs etc to avoid tax or simply spend down the GST non-exempt trust assets first, as is normally encouraged in trust drafting/administration. If the child or children have taxable estates themselves and are not charitably inclined, the calculation is much more complicated – is saving 40% in estate tax a generation from now better than saving 20-35% income tax (depending on state and beneficiary's rate) on assets likely sold before death? Again, the wealthier the children, the less charitably inclined and the more unhealthy they are, the better it would be to limit the GPOA to GST exclusion available. The less the assets have special attributes (collectible, depreciable), the less likely to be sold and the less inherent gain, again, the better it would be to limit the GPOA to GST exclusion available. My personal observation is that most clients (and their children) would rather save $5 during their life than $10 at their death.

Don't forget to consider some sort of expression of general settlor intent along with a trust amendment mechanism to adapt to future changes in tax law (there are paragraphs in the first sample clause), or when attorneys more clever than you or I come up with better ways to draft such clauses.

Note #2 – Because a powerholder can choose whether to appoint to a "skip person" or not, query whether you want to amend the GPOA so that appointive assets are limited to GST exclusion whether assets are or would be appointed to a skip person or not, for the same reasons discussed regarding clauses to ignore a powerholder's charitable/marital deduction (see pages 35-39 in main article). For smaller estates, nothing would be lost, but for larger estates where the spouse has additional AEA due to DSUE, it could matter.

More Sample Language (Simplified versions)

Formula General Power of Appointment – Subject to the remaining provisions of this Section, my spouse has the testamentary power to appoint a certain portion of assets remaining in the Family Trust at my spouse's death. My spouse may appoint the largest portion of the assets of this trust which would not increase any federal [or state] estate tax payable by my spouse's estate [without taking into consideration any charitable or marital bequest by my spouse that would be deductible by her estate pursuant to IRC §2055 or §2056] to my spouse's creditors or to my descendants in such amounts and subject to such terms, including trusts, as my spouse directs.

[note, this has no reference to IRD, insurance, loss assets, cash, etc – the bracketed language regarding state estate tax and whether to gross up with the charitable/marital deduction is discussed earlier in this paper. However, this is very simple, and apparently tracks the PLRs that used GPOA capping language – a slight variation is below.

Formula Fractional General Power of Appointment. Subject to the remaining provisions of this Section, my spouse has the testamentary power to appoint a certain fraction of the assets remaining in the Family Trust at my spouse's death. My spouse may appoint the largest fraction of the assets of this trust which would not increase any federal [or state] estate tax payable by my spouse's estate [without taking into consideration any charitable or marital bequest by my spouse that would be deductible by her estate pursuant to IRC §2055 or §2056] to my spouse's creditors or to my descendants in such amounts and subject to such terms, including trusts, as my spouse directs. The assets subject to the general power of appointment shall be those assets which, within the fraction, have the greatest difference between the basis of the asset, and the fair market value of the asset, excluding any income in respect of a decedent.

Sample Language for Exercising LPOA for Bypass (Family) Trust in Order to Trigger the Delaware Tax Trap to Adjust Basis for Appreciated Assets

(to be included in Will or Living Trust, as directed by original document)

Pursuant to paragraph X of my spouse's trust dated xx/xx/xxxx, I was granted a testamentary limited power to appoint the assets of said trust by specifically referring to that power in my (will, living trust or other deed). I hereby exercise that power as follows:

1) I hereby appoint the following assets to the [Surviving Spouse's Trust for a child or other intended beneficiary that grants the beneficiary a PEG Power – presently exercisable general power of appointment] or [the XYZ Family Delaware Tax Trapping Trust dated ______ (insert my date of death), which shall be identical to the subtrust under Article III, Paragraph A of the XYZ Trust dated XX/XX/XXXX, whose terms are incorporated herein, with the exception that this trust shall have the following additional paragraph applied: "During my child's lifetime, my child shall have a presently exercisable general power to appoint any or all assets of this trust to his or her creditors, to him or herself or to any of my descendants in such amounts or under such terms as my child deems appropriate." **:**

COPY LANGUAGE FROM FORMULA GPOA ABOVE HERE (inclusive or exclusive definition)

2) I hereby appoint all remaining assets of the XXXX trust that were not appointed in Paragraph 1 to the [Surviving Spouse's Trust that does NOT grant anyone a PEG Power, and the trust that would probably be allocated any GST exemption].

Sample Language for an LPOA in a Bypass (Family) Trust Designed to be Eligible to be Retained Even When Trust is Funded Via Qualified Disclaimer – Still Allowing the Surviving Spouse Dispositive Control in Order to Trigger the Delaware Tax Trap to Adjust Basis for Appreciated Assets

(see discussion in Part IV – remember, limited LIFETIME powers might trigger a gift tax if the powerholder has a mandatory income interest even if DTT is not triggered– if it is done in such a way as to trigger the DTT, it DOES trigger a taxable gift under IRC §2514, regardless of whether a spouse has mandatory income interest – but many spouses couldn't care less – the income tax benefit of spraying income may far outweigh any gift tax ramifications)

During my spouse's lifetime and upon my spouse's death, my spouse shall have the power to appoint, from income or principal, in cash or in kind, all assets of this trust to a trust or trusts for any or all of my descendants that qualifies the transfer as a taxable gift or bequest under IRC §2514(e) or §2041(a)(3), such as a trust for my descendant that grants my descendant a presently exercisable general power of appointment or a trust that would otherwise trigger taxable gifts/bequests under applicable state law. All other appointees are excluded, specifically my spouse, my spouse's estate, my spouse's creditors, and creditors of my spouse's estate, in addition to any other party not described above.

In addition, during my spouse's lifetime, my spouse shall have the power to appoint, from income or principal, in cash or in kind, assets of this trust to any or all of my descendants, but limited to amounts necessary for their health, education or support. This paragraph should not be interpreted to grant my permitted appointees any property interest as a result of being a permitted appointee, and my spouse shall have no fiduciary duty whatsoever to them during my spouse's lifetime under this paragraph. The above limitations shall serve as a ceiling to limit my spouse's ability to direct the beneficial enjoyment of property pursuant to Treas. Reg. §25.2518(e)(2) and (e)(5) Example 6.

The above power of appointment is intended to be retained while still qualifying any transfers made to this trust pursuant to my spouse's disclaimer, pursuant to IRC § 2518 and the exception for retained spousal rights to direct the beneficial enjoyment of property under Treas. Reg. §25.2518(e)(2). It shall be interpreted accordingly.

Sample Language for a Partial Release of a Broad LPOA in a Bypass (Family) Trust where the Surviving Spouse Desires to Fund Bypass via Qualified Disclaimer – Still Allowing the Surviving Spouse Dispositive Control in Order to Spray Income and/or Trigger the Delaware Tax Trap at Death to Increase Basis for Appreciated Assets

Example of when to use this: John and Jane have basic AB trusts, with broad LPOAs in the bypass trust. The trusts are mostly unfunded, then John dies. Jane proposes to disclaim her POD/TOD/JTWROS interests, in which case the assets will pour into the Bypass, but retention of a broad LPOA would taint the disclaimer (it would result in a taxable gift, loss of asset protection, full 2036 inclusion, full step down at second death). Jane could disclaim the entire LPOA, losing the tax flexibility to spray income and get a step up in basis at second death, or, for potentially better income tax results, she may execute a partial release as envisioned below. When she then disclaims, the retained LPOA, which can only be exercised in a way to trigger estate/gift tax, should meet the exception in the qualified disclaimer regs cited below.

Pursuant to paragraph X of my spouse's trust dated xx/xx/xxxx, I was granted a limited [testamentary] power to appoint the assets of said trust by specifically referring to that power in my (will, living trust or other deed). I was granted the power to appoint to _____________________ [often this will be either to descendants or to anyone but the powerholder, powerholder's estate or creditors of either], which includes the power to appoint to a trust therefore [usually trusts include this power – if yours does not, check state law (common law under Restatement is favorable), which probably includes it anyway].

[to use if a *lifetime* power is granted in the original trust] As to my limited power to appoint during my lifetime, I hereby partially release and disclaim the above mentioned power **except** that I shall retain **only 1)** the power to appoint to a trust for the permitted appointees that will trigger a federal gift tax under IRC §2514(e) upon transfer and 2) the power to appoint to any of the permitted appointees directly, but limited to amounts necessary for their health, education or support. I hereby release and disclaim the power to appoint during my lifetime beyond the appointees or amounts described above.

[more common – to use if a *testamentary* power is granted in the original trust] As to my limited testamentary power to appoint upon my death, I hereby partially release and disclaim the above mentioned power **except** that I shall retain **only** the power to appoint to a trust for any or all of the permitted appointees that will trigger a federal estate tax under IRC §2041(a)(3) upon transfer. I hereby release and disclaim the power to appoint to any other appointee.

This release/disclaimer is intended to qualify any future or contemporaneously executed disclaimer that would cause a transfer to the trust referenced above, such that the rights retained after release/disclaimer comply with the requirements of IRC § 2518 and the exception for retained spousal rights to direct the beneficial enjoyment of property under Treas. Reg. §25.2518(e)(2) and (e)(5) examples 6 and 7. It shall be interpreted accordingly and shall be given effect regardless of whether this release/disclaimer of interests is itself a qualified disclaimer under IRC §2518.

Note – There is no example in the §2518 Regs of whether such a disclaimer is “qualified” (is it “severable”?), which is why I referred to the above as a “release” and/or “disclaimer”, not a “qualified disclaimer”. See §25.2518-3(A)(iii) and examples 9 and 21 in that Reg for disclaiming POAs, which are considered as separate property interests for disclaimer purposes. Whether the above would be “qualified” is irrelevant, at least for the limited purpose of this Release, which is to prepare another disclaimer to be qualified – a release may accomplish the same thing as a qualified disclaimer in some cases without ill effect. For a great example of a clever use of a partial **release** of a GPOA to qualify a trust as a “see through trust”, see PLR 2012-03033. If a GPOA is released (not a qualified disclaimer), it would be a gift taxable event based on the underlying assets (see IRC §2514(b)) (although it may be delayed by being an incomplete gift if powers are retained as contemplated by a partial release), but a release of an LPOA, or portions of an LPOA, would not be– see Treas. Reg. §25.2514-3(e) example 3 “If in this example L had a power to cause the corpus to be distributed only to X, L would have a power of appointment which is not a general power of appointment, the exercise or release of which would not constitute a transfer of property for purposes of the gift tax.”

Sample Lifetime Limited Power to Appoint to Enable Surviving Spouse to Spray Income to Children and/or Charities

(including provisions limiting such powers for see-through trust status for retirement benefits and qualified subchapter S trusts – obviously this is not for marital trusts, practitioners in states with separate state estate/inheritance taxes should investigate to what extent such powers might affect trusts intended to qualify for that state's separate estate/inheritance tax marital deduction – practitioners in those states may divide a bypass/credit shelter trust between a "B1" share that is state estate exempt and a "B2" share that is eligible for separate state QTIP – if necessary, a lifetime limited power of appointment might be limited to only the "B1" share if that would save state estate taxes)

The trustee shall distribute all or any portion of the trust estate, from income or principal, as my spouse may appoint during my spouse's lifetime, to any of my descendants, in trust or outright. [Any appointment that is not equal to my children or their issue per stirpes may only be made with permission of _______, or the unanimous permission of my children, or their representative issue per stirpes. – Some may fear a surviving spouse might be unduly influenced by one child to make unequal distributions thwarting an intended equal estate plan. Some may not care if their surviving spouse does this, and there may be very good reasons to make unequal distributions. In my experience, more than half would opt to allow their spouse more flexibility and trust their spouse's judgment and sense of fairness. Because a lifetime LPOA is not intended to trigger gift/estate tax, we really don't care for tax reasons whether a non-adverse or adverse party consent is required.]

This limited power of appointment shall not be exercisable, directly or indirectly, to discharge any legal obligation of the powerholder.

In addition, the trustee shall distribute all or any portion of the trust estate as my spouse may appoint during my spouse's lifetime, whether such income is allocated to accounting income or principal, to any one or more organizations each of which is, at the time contemplated for an actual distribution to such organization, exempt from federal income taxation under § 501(a) as an organization described in § 501(c)(3). These appointive assets shall be limited further as follows:

2) only from gross taxable income as contemplated under IRC §642(c) [as discussed herein, this might also be further limited to higher tax rate income, but many clients would want the broader ability to spray even "lower rate" LTCG/QD income], and
3) only from gross income that would not otherwise be unrelated business income pursuant to Treas. Reg. §1.642(c)-3(d), IRC §681(a) and regulations thereunder (such as taxable income from an ongoing closely held business)

It is my intention under this provision that any such appointments qualify for an income tax deduction pursuant to IRC §642(c), as amended, and this provision shall be construed and may be amended accordingly.

NOTE: If the trust is intended to be a "see through trust" holding qualified plan/IRA benefits, you will want to modify lifetime powers accordingly, *depending on whether the trust is a conduit or accumulation trust*. As noted elsewhere herein and in other articles and CLE outlines, it is probably better, especially when using more flexible tax provisions such as the above, to have such benefits in a separate trust altogether because it is unclear whether you can adequately trace or convince the IRS that you are adequately tracing and limiting any accumulations from those retirement benefits. Remember that a trust may qualify as a conduit for a spouse even if other younger beneficiaries might be entitled to distributions (be a "see through trust" with the spouse's life expectancy as measuring life/"designated beneficiary"), but if younger beneficiaries might take via LPOA, the spouse would not be "sole beneficiary" and therefore would lose the other two major benefits – a potentially delayed required beginning date and recalculation of life expectancy every year. However, if you have an accumulation trust, you might lose those two advantages, but you can retain a spray power, as long as the potential appointees are all younger individuals, which would allow shifting high bracket ordinary income.

[For a conduit trust intended to achieve "sole beneficiary" status – Notwithstanding the above paragraphs, my spouse's lifetime limited powers to appoint shall not apply to any deferrable retirement benefits [you might want to have/refer to a definition for this], and such assets shall not be considered appointive assets subject to this power, nor shall this lifetime power to appoint apply to any benefits temporarily received as a distribution from a retirement plan that must be thereafter distributed to my spouse. It is my intention that this lifetime limited power of appointment be subordinate to the conduit trust provision in paragraph ____.

[For conduit trust where "sole beneficiary" status not sought, or accumulation trust - Notwithstanding the above paragraphs, my spouse's lifetime limited powers to appoint shall not be further limited as to any deferrable retirement benefits [you might want to have/refer to a definition for this]. My spouse may only appoint retirement benefits during my spouse's lifetime to my descendants outright. This may include qualifying trusts for my descendants only if a copy of the trust is given to the IRA custodian/trustee by October 31 of the year after my death and said trust would otherwise qualify as a see through trust/designated beneficiary itself.]

Notwithstanding the above paragraphs, my spouse may not exercise any lifetime limited power of appointment over any S Corporation stock or distributions therefrom, over which a qualified subchapter S corporation (QSST) election has been made, nor from any trust portion over which a marital deduction was or will be elected as qualified terminal interest property under federal estate tax or its applicable state estate tax law equivalent.

Note – if there is testamentary formula GPOA, the spouse may be triggering a taxable gift by exercising a lifetime limited power of appointment. So a lifetime power works optimally for gifts beyond the annual exclusion amounts if the "optimal basis increase" clause is a lifetime testamentary limited power of appointment intended to trigger the Delaware Tax Trap under §2041(a)(3) to increase basis. However, any formula testamentary GPOA will exclude certain assets, such as retirement plan/IRD. Could we fashion a lifetime power to **only** come from those excluded assets to avoid §2514? Probably, but it is unclear how that would play out, especially for assets such as cash that might be excluded from a formula TGPOA one day, and included the next. For many middle income taxpayers with plenty of estate/gift tax exclusion, this would not be an issue, and income tax savings goals would trump saving any superfluous estate/gift tax exclusion. However, we would want to warn clients of the possibility of its application – and for some clients, it may matter. Similarly, if the spouse had a §678(a) power or is otherwise entitled to mandatory income, using a lifetime limited power of appointment could also trigger a gift tax or possibly even trigger an assignment of income even if there is no testamentary GPOA. See the *Regester* and *Self* cases discussed in footnote 154.

SEE NEXT SAMPLE CLAUSE ON ANOTHER WAY TO GET AROUND THIS.

Sample Trustee Spray Power and/or Lifetime Limited Power to Appoint to Enable a Party Other than Current Beneficiary (spouse) to Spray Income to Children and/or Charities

As discussed in the notes to the previous sample lifetime LPOA clause, there are some drawbacks to the surviving spouse being granted a lifetime POA – in some cases it may trigger a taxable gift or an assignment of income. Of course, giving an independent trustee spray powers is one way to get around these rules. However, in my experience, settlors do not want to give independent trustees such broad spray powers at the expense of the surviving spouse, trustees don't necessarily want it because of the increased administration, due diligence and liability, and there may be additional reporting, accounting and notice requirements as well – trustees would have fiduciary duties to the beneficiaries under a traditional spray provision (which can also be viewed as a fiduciary lifetime limited power of appointment). One way to alleviate some, but not all, of those concerns would be to grant a spouse a veto power regarding any such distributions by the trustee. The other way, to me, preferred, is to grant a non-fiduciary lifetime limited power to appoint to someone other than the surviving spouse (this is known as a collateral power) – this prevents many more of the issues noted above.

The trustee shall distribute all or any portion of the trust estate, from income or principal, as _____________ (someone other than the spouse) may appoint during my spouse's lifetime, to any of my descendants, in trust or outright. In addition, the trustee shall distribute any portion of the trust estate, *but only from gross taxable income*, as __________ may appoint during my spouse's lifetime, whether such gross taxable income is allocated to accounting income or principal, to any one or more organizations each of which is, at the time contemplated for an actual distribution to such organization, exempt from federal income taxation under § 501(a) as an organization described in § 501(c)(3).

Any appointment may only be made with permission of [my spouse, or my spouse's agent, conservator or guardian][unanimous consent of my spouse's children].

Any lifetime power of appointment should constrain see through trusts/QSSTs as noted in prior sample language.

Would a spousal consent to someone else's appointment somehow a negative ramification? This is unlikely, but possible, depending on the issue, thus the bracketed examples of granting a spouse a veto power versus other parties who would indirectly act on behalf of a spouse. While the former is probably sufficient, the latter would be safer in all events.

Draft Provision to Enable and Order Distributions to be Carried Out to Beneficiaries

Trust Accounting for Discretionary Distributions to Beneficiaries

"To the extent that discretionary distributions are made from principal, the trustee shall make them and/or account for them in the books, records and tax returns of the trust in the following order:

1) from any current year net short-term capital gains, except those net gains attributable to disposition of property held in a trade or business not described in IRC §1411(c)(2), or attributable to disposition of an active trade or business as described in IRC §1411(c)(4);

2) from any current year taxable income attributable to assets described in IRC §1411(c)(1)(A)(i), such as an annuity payment, that was allocated to principal.

3) from any current year taxable income attributable to a qualified retirement plan distribution described in sections 401 (a), 403 (a), 403 (b), 408, 408A, or 457 (b) allocated to principal

4) from any remaining current year net short term capital gains or taxable ordinary income allocated to principal not described in the above paragraphs

5) from any current year long-term capital gains, except those net gains attributable to disposition of property held in a trade or business not described in IRC 1411(c)(2), or attributable to disposition of an active trade or business as described in IRC 1411(c)(4);

6) from any remaining current year long-term capital gains not described in the above paragraphs.

7) lastly, from other principal.

This paragraph is intended to ensure compliance with Treas. Reg. §1.643(a)-3(b)(2)"

Draft of Proposed Opt-In Rule Against Perpetuities Amendment for Adoption in States to Provide Improved Tax, Estate and Asset Protection Planning Options for their Citizens

(portions plagiarized from 25 Del. Code §§ 501, 504, with an opt in feature added)

Ohio Rev. Code proposed §2131.08(H):

Notwithstanding any other provision of this chapter, in the case of a nongeneral power of appointment over property held in trust (the "first power"), and only wherein the instrument exercising the power either

a. specifically refers to this paragraph, or
b. specifically asserts an intention to trigger Section 2041(a)(3) or Section 2514(e) of the Internal Revenue Code of 1986, or
c. specifically asserts an intention to postpone the vesting of any estate or interest in the property which was subject to the first power, 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

then, and only to the extent intended and specified in the instrument, any estate or interest in property, real or personal, created through the exercise, by will, deed or other instrument, of the first power, irrespective of the manner in which the first power was created or may be exercised, or whether the first power was created before or after the passage of this section [alternatively, "but only if the date of creation of that nongeneral power of appointment is on or after the effective date of this section], shall, for the purpose of any rule of law against perpetuities, remoteness in vesting, restraint upon the power of alienation or accumulations now in effect or hereafter enacted be deemed to have been created at the time of the exercise and not at the time of the creation of such power of appointment.

[Ohio defines non-general power in another statute, otherwise you might add something like "and the first power may not be exercised in favor of the donee, the donee's creditors, the donee's estate or the creditors of the donee's estate"]

Also – You might add "testamentary", or limit to 2041(a)(3), since there would not be much use in triggering a taxable gift under 2514(e). However, might you have a case of a GST non-exempt trust where someone wants to appoint and use their gift/GST exemption? Perhaps someone more creative than I can find a use, but I can't see much harm in including the gift possibility as long as the appointment has to affirmatively opt-in.

I don't think the bracketed language above is necessary, since I don't think an opt-in statute has the danger of inadvertently causing some calamity based on application to existing LPOAs, but I'm still thinking this over a bit. Comments welcome.

Decanting and Trust Agreement

This declaration of **decanting and trust agreement** is executed in the State of __________, on the date hereafter set forth, by **___________________________**, as Trustee.

Whereas:

1. The Settlor, _______________________________, created an irrevocable trust [revocable trust made irrevocable by the settlor's death on XX/XX/XXXX], the __________________________trust ("First Trust"), attached hereto.

2. **____________________________** is now acting as sole trustee of the First Trust, which is now in existence. [or amend for co-trustees accordingly]

3. Pursuant to Article XX, Paragraph YY, the First Trust provides that the Trustee may in its discretion make distributions to Settlor's spouse, ________________________, for her "[insert terms from trust that indicate broad trustee discretion to distribute]." (if you don't have broad discretion, but HEMS, then go to plan B, see subsequent sample).

4. Ohio R.C. §5808.18(A) provides in pertinent part, that "If a trustee of a trust, *** has absolute power***to make distributions of principal to one or more current beneficiaries, that trustee may exercise that power by distributing all or any part of the principal subject to the power, and all or any part of any income that is not otherwise currently required to be distributed, to the trustee of another trust, ***that is for the benefit of one or more current beneficiaries of the first trust*** If property is distributed pursuant to the authority described in division (A) of this section, the governing instrument may do***the following: (a) Grant a power of appointment to one or more of the beneficiaries for whose benefit the property was so distributed, including a power to appoint trust property to the power holder, the power holder's creditors, the power holder's estate, the creditors of the power holder's estate," [note: most state decanting laws allow granting an LPOA/GPOA if the trustee has broad discretion. Consult this list of decanting statutes with analysis of each state's power to add POAs at http://www.sidley.com/state-decanting-statutes/ and insert your applicable state statute or case law citation in lieu of the Ohio statute above. If your state has no decanting power, you may be able to change situs to one that does using a nonjudicial settlement agreement or other trust power.]

5. [Use if state law requires notice to beneficiary, but frankly even if prior notice is not required pursuant to statute it's probably a good idea or may even be required under other fiduciary duties.] Pursuant to Ohio R.C. §5808.18(F), all current beneficiaries are entitled to at least 30 days written notice of this distribution unless all current beneficiaries waive this. Evidence of this notice and/or waiver is attached herein.

Now Therefore:

The undersigned Trustee hereby directs that all [or, alternatively, a trustee might only decant those assets capable or desiring of a step up in basis] of the Trust assets of the First Trust shall be distributed to ____________________________________, as Trustee of the Second Trust (as defined herein), to be administered as a part thereof.

"Second Trust" means the trust created under this instrument. The terms of the Second Trust shall be the same as the terms of the First Trust, which terms are incorporated herein by reference, except for the additional provisions as set forth below:

1. Trustee hereby grants to ___________________ [settlor's spouse or other beneficiary] a testamentary general power of appointment [limited power of appointment] as follows:

INSERT PARAGRAPHS GRANTING GPOA or LPOA TO TRIGGER §2041(a)(3) HERE

Consider – if the state decanting statute does not allow for removal of a GPOA/LPOA (many decanting statutes are silent on this issue and only specifically permit ADDING one rather than removing one), then you might add an expiration period (aka "Boomerang clause"), which lets the trust lapse back to its original state and would force the trustee to keep on top of the issue and periodically renew the decanting (or better, a default might be to lapse only upon trustee's affirmative action). Another solution would be to add as part of the decanting a trust protector/amendment provision that would allow the subsequent removal, addition or amendment of the POA (this would be my preference). Why? What if Congress amended §1014/§2041 someday or the powerholder incurs significant debt? Along those lines, see the statement of settlor intent embedded in some of the sample clauses to permit the POA to be amended to conform with that intent.

IN WITNESS WHEREOF, ________________________ [through its duly authorized representative], hereby signs this instrument in its (his/her) capacity as both Trustee of the First Trust and as the Trustee of the Second Trust, on the date hereinafter set forth.

____________________________, Trustee

By: ________________________________

Date: ______________________________

STATE OF OHIO	)	
	)	SS.
COUNTY OF WARREN	)	

The foregoing instrument was acknowledged before me by _________________________ [on behalf of **_________________________________]**, Trustee on ____________________, 2014.

(SEAL) ______________________________________

Notary Public

This Instrument was Prepared By:

____

Notice Letter to Current Trust Beneficiary regarding Decanting

Date

Re: XYZ Trust dated XX/XX/XXXX

Dear _________ ,

As we have previously discussed, this letter is to give you formal notice of our intention to distribute all [or, as discussed above, only certain assets] of the assets of the above trust to a new trust. The terms of the new trust will be identical to the terms of the old trust except that the new trust will grant you a general power to appoint the assets in the trust at your death to the creditors of your estate [alternately, the decanting might only grant a limited power]. The proposed amendment and distribution, called a "decanting" is attached to this notice.

You have given us an approximate net worth statement attesting to your solvency and have told us that you are not co-signed on any loans or know of any outstanding debts or potential claims against you other then those on the net worth statement. The reason we asked you questions regarding this was to protect the trust and beneficiaries from any potential future creditors of your estate. The purpose of adding this clause is to ultimately benefit your children and/or grandchildren who will be entitled to receive the assets of the trust upon your death.

Under the current trust, the assets of this trust would not included in your taxable estate, and they would not receive a step up in basis at your death. The approximate amount of this appreciation as of the last end of quarter was $800,000 [insert approximate value].

This newly added general power of appointment should cause the assets of this trust to be included in your estate for federal estate tax purposes at your death, but only to the extent it does not cause an estate tax liability to occur. More importantly, this should cause any appreciated trust assets held in the trust to receive a step up in basis for income tax purposes.

This may ultimately save the children and/or grandchildren approximately 15-30% income tax on this appreciation, potentially saving them hundreds of thousands of dollars, depending on where they reside, the nature of the gain and asset appreciation at the time, when they sell the assets and other factors.

This amendment will be effective 30 days from this letter. However, you may not want to delay the amendment this long. Should you prefer to make it effective immediately, you may waive the 30 day notice requirement by emailing or sending us a short note such as "I hereby waive the 30 day notice requirement mentioned in your letter and proposed agreement dated ______".

Sincerely,

Trustee

Decanting and Trust Agreement
(where trust pays all net income or has HEMS type ascertainable standards – §5808.18 "paragraph B" decanting)

This declaration of **decanting and trust agreement** is executed in the State of ___________, on the date hereafter set forth, by **_____________________________**, as Trustee.

Whereas:

1. The Settlor, _________________________________, created an irrevocable trust [revocable trust made irrevocable by the settlor's death on XX/XX/XXXX], the ____________________________trust ("First Trust"), attached hereto.

2. **______________________________** is now acting as sole trustee of the First Trust, which is now in existence. [or amend for co-trustees accordingly]

3. Pursuant to Article XX, Paragraph YY, the First Trust provides that the Trustee shall pay all net income at least annually, plus in its discretion may pay additional sums of principal, up to the entire trust, to Settlor's spouse, _________________________, for her "health, education, maintenance and support [insert terms from trust]."

4. Ohio R.C. §5808.18(B) provides in pertinent part, that "Unless the trust instrument expressly provides otherwise and subject to the limitations set forth in this section, a trustee of a first trust who has power, other than absolute power as described in division (A) of this section, under the terms of the first trust to make distributions of principal to one or more current beneficiaries may exercise that power by distributing all or any part of the principal subject to the power, and all or any part of any income that is not otherwise currently required to be distributed, to the trustee of a second trust." The trustee hereby states that as of this decanting, all currently distributable net income has been paid. Ohio R.C. §5808.18(B) further provides "The second trust may be a trust ***** created by the trustee of the first trust. The power described in this division may be exercised whether or not there is a current need to distribute trust principal under any standard contained in the first trust. The exercise of a trustee's power under this division is valid only if the governing instrument for the second trust does not materially change the interests of the beneficiaries of the first trust." [note: see points regarding decanting statutes in general in previous sample].

5. Due to the limited nature and limited changes below, this decanting will not affect the beneficiary's entitlement to income nor the trustee's distribution standards, nor materially change the interests of the beneficiaries of the first trust.

6. [Use if state law requires notice to beneficiary, but frankly even if prior notice is not required pursuant to statute it's probably a good idea or may even be required under other fiduciary duties.] Pursuant to Ohio R.C. §5808.18(F), all current beneficiaries are entitled to at least 30 days written notice of this distribution unless all current beneficiaries waive this. Evidence of this notice and/or waiver is attached herein.

Now Therefore:

The undersigned Trustee hereby directs that all [or, alternatively, a trustee might only decant those assets capable or desiring of a step up in basis] of the Trust assets of the First Trust shall be distributed to ____________________________________, as Trustee of the Second Trust (as defined herein), to be administered as a part thereof.

"Second Trust" means the trust created under this instrument. The terms of the Second Trust shall be the same as the terms of the First Trust, which terms are incorporated herein by reference, except for the additional provisions as set forth below:

1. Trustee hereby grants to ___________________ [settlor's spouse or other beneficiary] a testamentary general power of appointment [limited power of appointment] as follows:

INSERT PARAGRAPHS GRANTING NARROW TESTAMENTARY GPOA or LPOA TO TRIGGER §2041(a)(3) HERE

Some may argue that adding a narrow testamentary power of appointment would "materially change the interests of the beneficiaries of the first trust", principally of course the remaindermen. For certain, it would make their vested interests subject to divestment, or at least some form of divestment – if, for example, the trustee added an LPOA that only allowed appointment to trusts for children in equal per stirpes shares, granting them a PEG power, as opposed to the residuary of the trust which simply distributes to the children outright, is this really a "material change" for purposes of Ohio's decanting statute? I doubt any beneficiary or Ohio court would see that as material, but it's still enough to trigger the Delaware Tax Trap and may save the family hundreds of thousands of dollars in income tax.

IN WITNESS WHEREOF, _________________________ [through its duly authorized representative], hereby signs this instrument in its (his/her) capacity as both Trustee of the First Trust and as the Trustee of the Second Trust, on the date hereinafter set forth.

____________________________, Trustee

By: ________________________________

Date: ______________________________

STATE OF OHIO)
) SS.
COUNTY OF WARREN)

The foregoing instrument was acknowledged before me by _________________________ [on behalf of **_________________________________]**, Trustee on ____________________, 2014.

(SEAL) ______________________________________
Notary Public

This Instrument was Prepared By:
____
____

If you are in Ohio or a state like Ohio, attach notice or waivers of notice.

Examining Irrevocable Trusts for Opportunities to Step Up Basis at Death of Beneficiary

1) Does the trust grant the beneficiary a *general* power of appointment, allowing the beneficiary to appoint to himself, his estate or creditors or either? Or, does the trust direct the trustee to pay debts/creditors of the decedent/beneficiary? If yes, then **stop** – the assets in the trust will receive a date of death basis.[240]

2) Does the trust name the beneficiary as controlling trustee, or allow the beneficiary to name themselves as controlling trustee, without any ascertainable standards as to distribution to that beneficiary? And, is the trust sitused in a state that does not have a savings statute to graft ascertainable standards upon the trust? If yes, then **stop** – the assets in the trust will receive a new basis on the beneficiary's death. These would be very rare, and trusts or states often have a savings clause preventing this result.

3) Could the trust have otherwise initially qualified for a QTIP election (all income to spouse, no other beneficiary, etc) *and no Form 706 was filed*? Consider filing Form 706 with a late QTIP election, so that trust gets a second step up in basis when the surviving spouse dies.

4) Does the trust have a trust protector/advisor or other clause permitting a trust protector, trustee or other non-adverse party the ability to add a GPOA or LPOA? If the powerholder is still alive, add it but release/disclaim any power to add a GPOA over cash, loss assets, IRD, etc, or assets exceeding a powerholder's available AEA. If not, and it was not added, argue that such a power in itself is a GPOA held by spouse merely requiring the consent of a non-adverse party, hence a GPOA per §2041(b)(1)(C)(ii)

5) Does the trust grant the beneficiary a *limited* testamentary power of appointment? The clause does not have to use those words precisely; it must merely allow the beneficiary to direct where assets go at their death. If yes, then does the trust permit the beneficiary powerholder to appoint to a trust or "for the benefit of" individual beneficiaries? Most state laws will allow appointment to trust if the trust/power is silent. See Restatement of Property, Third, Donative Transfers, §19.13 and §19.14. If yes, then go to step 6. If no, go to step 7.

6) Has the powerholder appointed to a trust or subtrust for intended permissible beneficiaries, granting one or more of them a presently exercisable general power of appointment (withdrawal right, such as a Crummey power, or power of revocation), even if it's only a present power of the remainder of the trust coupled with an income interest? If yes, then any assets so appointed will receive a new date of death basis. If the appointive

[240] This might occur in a GST non-exempt trust, for example. Certain categories of assets do not receive a new basis, such as annuities and retirement plans (income in respect of a decedent). Occasionally, the decedent's executor or trustee may elect an alternate valuation date which would use a date of subsequent sale within 6 months after death or 6 months after date of death. Because assets declining in value would receive a step *down* in basis, consider distributing or selling assets with substantial valuation declines prior to death if possible if a GPOA cannot be avoided.

trust has only a partial power, such as a withdrawal right limited to a 5/5 power, then this is likely pro-rated to only cause inclusion of 5% of the trust. If no, then do so.

7) Does the trustee have wide discretionary power to distribute corpus to the beneficiary and is governed by a state law that permits decanting? If yes, then the trustee may decant to add a GPOA/LPOA to enable a new basis at the death of the powerholder.[241]

8) Is the trust governed by the UTC or other state law that would allow a trustee or beneficiary to petition the court for an amendment to add a GPOA/LPOA? If yes, then the trustee may petition the court (or a beneficiary might, but see Part VII of article cautioning against the potential adverse effect of beneficiary actions) to amend the trust to add a narrowly crafted GPOA/LPOA to enable a new basis on the death of the powerholder.

[241] See list of decanting statutes with analysis of this power at http://www.sidley.com/state-decanting-statutes/

Forfeiture Provision to Add to Spendthrift Clause for Better Asset Protection, with an appropriate carve out for QSST, IRA, 678(a) (see other CLE material for tax lien clauses)
(first and 3d paragraph copied from *reported cases)*

If by reason of any act of any such beneficiary, or by operation of law, or by the happening of any event, or for any other reason except an act of the Trustee authorized hereunder, any of such income or principal shall, or except for this provision would, cease to be enjoyed by such beneficiary, or if, by reason of an attempt of any such beneficiary to alienate, charge or encumber the same, or by reason of the bankruptcy or insolvency of such beneficiary, or because of any attachment, garnishment or other proceeding, or any order, finding or judgment of court either in law or in equity, the same, except for this provision, would vest in or be enjoyed by some other person, firm or corporation otherwise than as provided herein, then any mandatory trust provisions or withdrawal rights herein expressed concerning such income and/or principal shall cease and such beneficiary may only receive distributions at the sole and absolute discretion of the trustee. In such event, the trustee may, in its sole discretion, make distributions to any descendants of the beneficiary, and if there are no descendants of the beneficiary, to my descendants.

In addition to the above events triggering a forfeiture and voiding of a beneficiary's mandatory interests and/or withdrawal rights, any filing in a court of domestic relations against a beneficiary or by a beneficiary, other than a petition for adoption or name change, such as for a divorce, dissolution or restraining order, shall expressly have the same effect as above.

The death of a beneficiary shall also constitute a complete termination of such beneficiary's interest in the trust and the trust estate and any payments accrued or undistributed by the trustee at the time of death of such beneficiary shall be distributed to the succeeding living beneficiaries or charities otherwise entitled to distributions from the trust estate. This paragraph shall not override any exercise of a testamentary power of appointment.

The above provisions shall not apply to remove a mandatory income interest from any trust share previously or currently qualified as a marital deduction trust or qualified subchapter S trust, or otherwise intended to qualify for the marital deduction or as a qualified subchapter S trust. The trustee's filing of an ESBT election shall conclusively be presumed to indicate an intent not to qualify as a QSST and hence the above forfeiture provisions shall apply to any trust over which an ESBT election has been made. The trustee/executor's failure to file Form 706/709 QTIP election for a trust that might otherwise qualify by the extended due date of the return shall conclusively be presumed to indicate an intent not to qualify for the marital deduction.

In addition, the above provisions shall not apply to remove a beneficiary's *current* sole power to withdrawal income pursuant to Paragraph XXX, which grants the power to withdrawal accumulated income during a window from December 15-December 31. In such case, the above provisions shall only apply prospectively to remove any future years' withdrawal rights, or, if the above triggers occur Jan 1-Dec 15, shall apply prospectively to remove the current year's withdrawal right.
The above provisions shall expressly apply to powers of revocation, withdrawal or any presently exercisable general power of appointment. [note – see the Castellano case as to why this is included)
NOTE: I have seen several spendthrift clauses that state that the entire clause does not apply to a marital trust or QSST or conduit trust. DON'T DO THAT. 2056 Regs specifically say it's OK to have a basic spendthrift clause preventing assignment, alienation, etc, just not one that goes further to work an actual forfeiture of the mandatory income interest.

Comparison of Various Trust Income Tax Shifting Options to Avoid Trapping Income in Trust

Companion chart to article, "The Optimal Basis Increase and Income Tax Efficiency Trust" - see p76-102 for further explanation of variations below
Assumes beneficiaries are not in top income tax bracket. 678a power assumes all income, rather than up to 5% (which might eliminate a few issues)
LLPOA=lifetime limited power of appointment. This does not discuss various trustee powers to adjust or convert to unitrust, which might shift burden.

	Key Features	678(a) Mallinckrodt Beneficiary-withdrawal	1.643(a)-3(b)(1) Treat CG as Accounting Income/DNI	1.643(a)-3(b)(2) CG distributed "books records tax returns"	1.643(a)-3(b)(3) actually distrib. or trustee uses determine amt	642(c) Charitable Deduction	Discretionary in kind distribution of unrealized gain asset (643e)	Using S corp with a QSST election
	Requirement of Distributions							
1	**Actual Distributions must be made to shift income** (caveat, for "simple" trusts requiring acct income to be paid some income may be shifted even if distribution not made)	no	yes	yes	yes	yes	yes	no (phantom inc.)
	Timing of Distributions							
2	**Can utilize 65 day election to make late distributions** (e.g. allowing early 2014 distributions to count as 2013 distr)	no	yes	yes	yes	no	n/a	no
3	**Can utilize 1 year election to make late distributions** (allowing any 2014 qualifying distribution to count as 2013)	no	no	no	no	yes	no	no
	Ongoing Income Tax Treatment and Flexibility							
4	**Can change year to year with trust protector/decanting or valid amendment to change governing instrument**	probably	probably	probably not	probably	probably	yes	n/a
5	**Can be used in conjunction with LLPOA/spray power**	no	yes	yes	yes	yes	yes	no
6	**Ability to shift capital gains as well as other income**	yes	yes	yes	yes	yes	yes	some
7	**Ability to spray ongoing business income (S/LLC)**	yes	yes	yes	yes	no	no	no
	Asset Protection Considerations							
8	**Subjects applicable income to creditors of beneficiary & more likely to be "available" if beneficiary divorces**	yes	no	no	no	no	no	yes
9	**Trustee discretion protects from abuse/undue influence**	no	yes	yes	yes	yes	yes	no
10	**Trust might require veto/consent of various parties to curtail extraordinary unwarranted distributions**	no	yes	yes	yes	yes	yes	no

	Federal Estate/Gift/GST Tax Features							
11	**Estate inclusion of income/ withdraw right via IRC 2041**	yes	no	no	no	no	no	no
12	**Gift tax possible if income released/assigned/appointed**	yes	no	no	no	no	no	yes
13	**Unwithdrawn Income subject to 2036 inclusion (>5%)**	yes	no	no	no	no	no	yes (stub QSST)
	Special Asset Tax Features							
14	**"See Through" IRA Trust (401(a)(9)) and QSST (S corp) Requires carve out from POAs to prevent distributions**	no	no	no	no	yes	no	yes
15	**Section 121 excl. for sale of residence if bene get CG**	probably	no	no	no	n/a	no	no
16	**Section 179(d) expensing problem for business assets**	no	yes	yes	yes	yes	n/a	no
17	**Can shift S Corp income to lower rates (assume > estate)**	yes	not ESBT	not ESBT	not ESBT	no	n/a	yes
18	**Can except muni/tax exempt income to keep in trust**	yes	no	no	no	yes	n/a	no
	State Estate & Income Tax Features							
19	**Allows effective"above the line" deductions many states**	no	no	no	no	yes	no	no
20	**Easily change to trap income to escape state income tax (e.g. if beneficiary later changes to high federal bracket)**	no (unless power removed)	yes, for CG or more if no distributions	no, CG must pass unless no distributions	yes, for CG or more if no distributions	n/a	yes (sell in trust)	no (ESBT req.)
	Trustee Issues, Tax Accounting, Administration							
21	**Failure to withdraw/distribute income complicates filing (is remaining trust a partial grantor trust under 678a?)**	yes	no	no	no	no	no	no
22	**Easy for trustee to determine/administer**	yes	no	yes	no	probably (tracing?)	yes	yes (once elected)
23	**Requires very competent trustee and/or accountant**	yes	yes	yes	yes	yes	yes	yes

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Comparison of Various Basic Trust Design Options for Married Couples

Companion chart to article, "The Optimal Basis Increase and Income Tax Efficiency Trust" - please consult for explanation of variations
(For simplicity, this chart does not compare intervivos SLATs, QTIPs, or other lifetime gifting options, though SLATs may also be adapted)
(Some "traditional" bypass or marital trusts may have more features than indicated, this chart compares the "ordinary" common trust for spouse)
(Some benefits may be limited/constrained by available applicable exclusion amounts. Assumes beneficiaries are not in top income tax bracket)

	Key Features	Outright Will or Trust (w/portability)	Traditional Bypass	Traditional QTIP	Traditional GPOA marital	Optimal Basis and Income Tax Efficiency Trust
	Basis Treatment at Death of Surviving Spouse					
1	**"Step up" in basis at 2nd death** (QTIP has potential for Rev. Proc. 2001-38 step up denial)	yes	no	probably	yes	**yes* (up to AEA)**
2	**No "Step down" in basis on 2nd death**	no	yes	no	no	**yes**
3	**Avoid potential lesser basis step up when fractional interests (LLC, TIC, etc) fund trust, at 2nd death**	n/a	no	no	yes	**yes* (up to AEA)**
	Basis Treatment at Death of Beneficiary (Child)					
4	**"Step up" in basis on child's death** (if dynastic style, protective trust, to extent GST exempt)	yes	no	no	no	**yes**
5	**No "Step down" in basis on child's death** (if dynastic style, protective trust)	no	yes	no	no	**yes**
	Ongoing Income Tax Treatment and Flexibility					
6	**Capital Gains Able to Escape Tax Rate Trap of 43.4% or 23.8% over $12,150 if bene is in lower bracket**	n/a	no	no	no	**yes**
7	**Ability to spray income (non-fiduciary) to lower tax bracket beneficiaries or possibly even charity**	no	no	no	no	**yes**
8	**Ability to spray capital gains as well**	no	no	no	no	**yes**
9	**Ability for "above the line" charitable deduction**	no	no	no	no	**yes**
10	**Ability for spouse to make lifetime tax-free"gifts"**	no	no	no	no	**yes***
11	**Ability for better tax treatment for special assets (personal residence, small business stock, etc)**	yes	no	no	no	**yes* (if §678(a) used)**

	Asset Protection Considerations					
12	**Inherited principal protected from creditors**	no	yes	yes	yes	**yes**
13	**Income from inherited assets protected from creditors**	no	if discretionary	no	no	**yes**
14	**Protection from divorce, remarriage, squandering spousal elective share, ERISA/REA, etc**	no	yes	yes	yes	**yes**
15	**Better incapacity/management capability**	no	yes	yes	yes	**yes**
16	**Potential Medicaid/govt benefits advantage**	no	yes	some	no	**yes**
	Federal Estate/Gift/GST Tax Features					
17	**Inherited assets escape estate tax at 2nd death**	no	yes	no	no	**yes**
18	**Allows dynastic GST use at first death (reverse QTIP)**	no	yes	yes	no	**yes**
19	**No need for timely filed 706/portability to exploit 1st decedent spouse's $5.34m+ estate/GST exclusion**	no	yes	no	no	**yes**
20	**Can save millions in add'l estate tax in event of simultaneous death if one spouse's estate > $5.34m+**	no	yes	yes	yes	**yes**
21	**Surviving spouse can remarry w/o jeopardizing first spouse's use of exclusion (i.e losing DSUE amt)**	no	yes	no	no	**yes**
22	**Enables disclaimer funding while still keeping a POA**	n/a	no	yes	yes	**yes**
	State Estate & Income Tax Features					
23	**Inherited assets escape state estate tax at 2nd death (to extent of exclusion, if not separate state QTIPed)**	no	yes	no	no	**yes**
24	**Ability to spray income to beneficiary in lower tax bracket or lower tax state**	no	if added	no	no	**yes**
25	**Ability to shelter trust income from state income tax for trust income (incl CG) not K-1'd to beneficiary See separate article on avoiding Ohio Trust Tax**	no	maybe	maybe	maybe	**maybe**

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