Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2946

Date:	**17-Mar-22**
From:	**Steve Leimberg's Estate Planning Newsletter**
Subject:	**Ed Morrow on PLR 202206008: Judicial Settlement Modification & Formula Testamentary General Powers of Appointment**

"In PLR 202206008, the IRS approved of a judicial modification (an approval of a settlement) of a GST grandfathered trust to add a formula testamentary general power of appointment that would enable the remainder beneficiaries or appointees to receive a step up in basis over such assets at the primary beneficiary (child of settlor) powerholder's death. The IRS ruled that 1) this addition did not disturb the GST exempt nature of the trust and that 2) it would cause estate inclusion over only the appointive assets, which amount was limited by formula to an amount that would not cause an increase in the powerholder's estate tax."

Ed Morrow provides members with his analysis of *PLR 202206008.*

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Here is his commentary:

EXECUTIVE SUMMARY:

In PLR 202206008, the IRS approved of a judicial modification (itself an approval of a settlement) of a GST grandfathered trust to add a formula testamentary general power of appointment that would enable the remainder beneficiaries or appointees to receive a step up in basis over such assets at the primary beneficiary (child of settlor) powerholder's death. The IRS ruled that 1) this addition did not disturb the GST exempt nature of the trust and that 2) it would cause estate inclusion over only the appointive assets, which amount was limited by formula to an amount that would not cause an increase in the powerholder's estate tax.

COMMENT:

In a nutshell, the PLR approved a judicial modification that added a formula general power of appointment to an irrevocable trust, over the following amount:

> The largest portion of Trust B that could be included in Child's federal estate without increasing the total amount of the 'Transfer Taxes' actually payable at Child's death over and above the amount that would have been actually payable in the absence of this provision.

The taxpayer asked for (and the IRS granted), two rulings. Let's quickly dispense of the first one regarding GST before tackling the more interesting issue regarding the formula power.

Generation Skipping Transfer Tax (GST Tax): Modifications of grandfathered GST exempt trusts can lose their exempt status if the modification shifts a beneficial interest in the trust to any beneficiary who occupies a lower generation. The modification of the trust in this PLR was doing the exact opposite of extending the vesting and pushing assets downstream to a lower generation – if anything, it was accelerating and causing estate inclusion earlier than would have occurred without the modification. So, from a GST standpoint such a modification should not worry the IRS – and they so ruled, as they have in many other PLRs on this topic.

Formula General Powers to Cap Estate Inclusion:

The second ruling request dealt with whether the trustee's adding of the power (approved by settlement agreement and the local court, pending a favorable PLR) caused inclusion in the Child's estate solely by virtue of adding the power or whether it would only cause inclusion over the desired amount. The IRS ruled that it would only cause inclusion over the appointive assets, as limited by the formula.

I have been advocating for the use of such formula testamentary general powers of appointment for well over a decade now, though perhaps with a few more limitations, requirements and ordering rules.[1] For trust beneficiaries who do not have a taxable estate (which, at $12.06 million per taxpayer with unlimited charitable and marital deductions, is at least 99.99% of the population), it's a no-brainer to at least consider causing estate inclusion for any appreciated trust assets that would benefit from a step up in basis, provided the inclusion does not rise to a level that would cause an estate tax. Note, however, that the provision in this PLR modification does *not* limit the appointive assets to only *appreciated* assets, so if the trustee happens to have bought assets that go down in value by the Child's death, the estate inclusion would cause a "step *down*" in basis for those assets, rather than a "step up."[2]

This PLR, of course, does not have any actual dollar amounts, but imagine a situation in which the settlor established a trust for a primary beneficiary (child of the original settlor) with $2 million, which has grown over the decades to $8 million of assets with an adjusted basis of $3 million, and the primary beneficiary's estate outside the trust is $2.5 million. Causing estate inclusion of the trust could increase the basis of the assets for the next generation (the grandchildren of the original settlor), which, depending on the state and federal income tax rate and types of assets, may be calculated to save approximately $5 million (the basis increase), times 30% (estimated state and federal income and net investment income tax rates on eventual sale, or depreciation savings) or about $1.5 million in income tax savings gained through causing estate inclusion. Failure to consider this type of planning could waste a tremendous opportunity.

With the formula in place, it would still be very beneficial in our example even if the applicable exclusion amount were dramatically reduced to $6 million or some other number by time of the Child's death. Such an event would simply reduce the basis increase benefit somewhat, without causing any additional estate tax. Unless there is an ordering rule to dictate which appointive assets the power applies to, the corresponding inclusion and adjustments to basis are likely to apply to the trust assets on a pro rata basis.[3]

Naysayers have argued that somehow limiting the scope of powers of appointment to certain assets or placing a cap on the amount will somehow be attacked by the IRS as fraudulent or suspect in some way - it can't possibly be that easy! Formula powers are too complicated, they argue. This is hogwash, of course, and just an excuse by practitioners to avoid learning a new trick. All statutory, regulatory, case law authority and rulings, including this new PLR, indicates that appointive assets can be limited and need not comprise the entire trust.[4] Formulas are used all of the time in planning, and are even included in examples in the regulations. Ironically, many trusts are drafted with complicated formula general powers to cause estate inclusion if it reduces overall estate and GST tax, with no consideration whatsoever as to whether such inclusion might be much more advantageous in creating a valuable *income* tax benefit.

It is easier to analyze the import of such clauses, however, when they are included at the outset. This PLR involved a decades old irrevocable trust that had no such provision, and modifications of already irrevocable trusts involve additional considerations that might cause counsel to seek a ruling. If someone is inclined to get a ruling on such a trust modification to clarify the GST and estate inclusion consequences as was done here, it may also be prudent to ask the IRS to rule on other income tax and gift tax consequences of the modification as well. It does not cost anything more to add this to the ruling request.

Potential Income Tax Issue Not Addressed: Many practitioners fail to consider that substantial trust modifications can potentially trigger income tax. There are arguments and rulings to that effect that should be considered as a possibility that a PLR could effectively foreclose (see discussion at this LISI Estate Planning Newsletter #2753 (October 9, 2019): *Potential Income Tax Disasters for Early Trust Terminations*). The modifications in this PLR are probably not substantially changing the beneficial interests of the parties materially enough to constitute a taxable exchange under IRC §1001, as was the case in PLR 200231011, but if you're spending $50,000 or so to get a PLR, you may as well ask for that in the ruling.

Potential Gift/Estate Tax Issue Not Addressed: Courts have ruled that beneficiary consent to modifications can be deemed a transfer for gift/estate tax purposes.[5] A potential argument that the PLR did not address was whether the grandchildren's consent to giving their parent a greater interest in the trust that allowed their interest to potentially be divested through the exercise of the general power of appointment might be a gift. The modifications here probably do not materially increase the value of the powerholder child's property interest or materially decrease the value of the consenting remainder beneficiaries' interests, but it couldn't have hurt to have confirmed this point either, even with the initial supposed opposition on their part.

There was some discussion in the ruling about how there was "controversy" and "opposition" by the beneficiaries prior to settlement, with the following rationale given for adding the general power:

> Trustee asserts that the exercise of this discretionary authority is to carry out the intent of Grantor to keep trust assets in the hands of Grantor's descendants upon Child's death and to minimize transfer taxation upon Trust B assets. However, according to Trustee, due to family dynamics, including separation and divorce, as well as changing tax laws, Grantor's intent may not be carried out.

To be charitable, this is simply window dressing. Granting the child a general power of appointment makes the grandchildren's interest demonstrably ***less*** rather than ***more*** secure, as their interest that was previously fully vested (locked in, near certain) is now *fully subject to divestment.* If creditors come after the powerholder's estate, the trust assets may be susceptible to creditors, not to mention the powerholder could change their mind and appoint to one grandchild to the exclusion of others, or, because it is a broad general power, to a new spouse, creditor, charity, or even the latest Instagram influencer.[6] Moreover, adding a general power is hardly needed to "minimize transfer taxation" – the trust was GST exempt already and would not have been included in the child's estate or cause a GST tax. It's more accurate to say that the changes were desired to minimize *income* taxes, rather than *transfer* taxes.

We can't fault counsel for some creative bootstrapping of rationales for the reformation though. Overall, adding a formula general power may be a great idea. The tremendous upside is worth the small risk and this risk can largely be mitigated through several techniques that were not discussed in the ruling. However, to imply that a *general* power was added for some purpose other than increasing the income tax basis, such as to protect the grandchildren's interest, is not particularly convincing. You don't need to grant a *general* power of appointment to protect the remainder beneficiaries - you only need a *general* power to step up the basis of the appreciated property subject to the power!

What should interest practitioners the most in the ruling is the formula nature of the power of appointment. It was not over the entire trust, but only over the largest portion of the trust that would not increase the transfer taxes applicable to the Child's estate.

Of course, the IRS had no problem with this formula general power, any more than it has historically had problems with A/B funding formulas dividing trusts between bypass and marital trusts, or between GST exempt and non-exempt trusts, or formula disclaimers.

There was no indication that the child had a testamentary limited power of appointment over the trust prior to the reformation that could have been used to trigger the Delaware Tax Trap.[7] If that were the case, the intended result could likely have been obtained without an expensive court reformation and IRS ruling request. If one is going to bother going to court and apply for a private letter ruling, however, it's probably better to go all the way and ask for a general power to be added rather than a limited one, because in some states it is more certain to trigger IRC §2041, and any appointive trust could be free of some undesirable trust clauses that some states require in order to trigger the Trap.[8]

Which brings us to the last paragraph of the IRS ruling on estate inclusion and a misstatement that readers should be wary of. The IRS stated that:

> *However, **the exercise** by Child of Child's testamentary general power of appointment will result in the appointed property being includible in Child's gross estate under § 2041(a)(2).*

This statement is extremely misleading. The Child's testamentary power of appointment does indeed result in the appointive property being includible in the Child's gross estate under IRC 2041(a)(2), but the ***exercise*** of the power is completely irrelevant. Estate inclusion over the appointive assets results whether the power is exercised or not, which is a key advantage of these clauses in exploiting the step up in basis loophole. The IRS may not have to issue a correction of the ruling, however, because the next sentence fixes the mistake and is more accurate in its conclusion:

> *Accordingly, based on the facts submitted and the representations made, we conclude that the exercise by Trustee of its discretionary authority over Trust B principal upon the terms of the Settlement Agreement will result in **only the trust property subject to Child's testamentary general power of appointment to be included in Child's gross estate under § 2041(a)(2)**.*

We shouldn't fear adding provisions that optimize the basis of trusts. That said, it is *prudent* to assume the possibility that the applicable exclusion amount may decrease (or, that a powerholder's estate might substantially increase). Even if the Build Back Better Act or some new bill does not decrease the applicable exclusion amount in the near future, we still have the sunsetting provisions on December 31, 2025 under the colloquially known as "Tax Cuts and Jobs Act". That doesn't mean we should turn our backs on the prospect of tax savings, but merely draft such powers with a cap and other prophylactic techniques to adapt to such prospects, as this PLR handily accomplished.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Ed Morrow

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CITATIONS:

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[1] *Ed Morrow & the Optimal Basis Increase Trust (OBIT)*, LISI Estate Planning Newsletter #2080 (March 20, 2013). An updated version is downloadable for free from the ssrn.com website.

[2] IRC § 1014 provides an adjustment to date of death (or alternate valuation date) basis for most assets included in someone's taxable estate (with some exceptions for income in respect of a decedent or IC-DISC assets). For most trusts over a long-term time horizon, the poorly performing assets either eventually recover or are sold over time to generate a capital loss, so it would not be surprising if all of the assets in this particular trust were either short-term bonds or highly appreciated stocks and funds. The parties may have been legitimately unconcerned about the need to prevent any "step down" in basis enough to limit appointive assets to only those assets with a basis lower than fair market value on the date of death and preferred to keep the formula as simple as possible to make it easier to the court and IRS to understand.

[3] Some argue that the trustee could choose the appointive assets over which the power applies when it is limited to some fractional or pecuniary amount of the estate and the inclusion would follow accordingly. Perhaps. I am skeptical that the trustee's post-mortem choice can direct which assets of the trust are included. We have no evidence of any specific language in this trust that gives instructions to the trustee in such event. This aspect of formula powers if discussed in the article cited above. It may be an important issue – imagine in our prior example that $5 million out of the $8 million corpus could be included in the trust without triggering estate tax, and the trust consisted of 30% short-mid term bonds worth $2.4 million with a basis of $2.3 million and 70% highly appreciated real estate and equities worth $5.6 million with a basis of only $700,000. Which would you rather have included as appointive assets? A pro rata portion of everything, or over the depreciated real estate first and then the other equities?

[4] Treas. Reg. §20.2041-1(b)(3). For more citations and discussion, see the above paper.

[5] For example, *Sexton v. U.S.*, 300 F.2d 490 (7th Cir. 1962), *cert denied* 371 U.S. 820 (1962).

[6] Any LISI readers watch HBO's *Succession*? It involves a blended family's battle over and a declining patriarch's changing desires about the succession and control of the family business and fortune. The first episode involved an irrevocable trust modification the patriarch had his children sign. I doubt they granted their dad a general power of appointment, but I confess as a trust and estate practitioner I'm curious to know what it said!

[7] The Delaware Tax Trap is a colloquial term for the effect of IRC §2041(a)(3) or IRC §2514(d), which provides that an exercise of a limited power of appointment that causes a distribution to another trust with certain terms is treated as a general power for transfer tax purposes. This may be very beneficial if it causes estate inclusion without estate tax, but may be costly if it actually causes additional estate tax. For more discussion on this point, see the above white paper.

[8] In many states, it is only possible to trigger the Trap by appointing to a Trust that contains a PEG power – a presently exercisable general power of appointment, something akin to a *Crummey* power, though it might be curbed in ways that *Crummey* powers might not be. Needless to say, it might not be desirable for various non-tax or transfer tax reasons to draft the appointive trust in this manner, despite the potential income tax benefits.

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