**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)****[[1]](#footnote-2)***

*By Edwin P. Morrow III, J.D., LL.M. (tax)*

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**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 $10.9 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. 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). Part V discusses various techniques to achieve a step up in basis at an older relative’s death, or that of the first spouse to die. Part VI posits new asset protection opportunities. Part VII explores 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 charts in the appendix.[[2]](#footnote-3)

* 1. **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]](#footnote-4) ATRA recently made this provision permanent, along with a $5,000,000 exemption for estate, gift and generation skipping transfer tax, adjusted for inflation. The Tax Cuts and Jobs Act doubles this for 2018-2025.[[4]](#footnote-5)

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]](#footnote-6) as well as a “fraud upon the public”.[[6]](#footnote-7) 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 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.

* 1. **What’s “wrong” with the traditional AB trust post-ATRA?**

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]](#footnote-8)

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.

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]](#footnote-9) 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]](#footnote-10) 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]](#footnote-11)

Yet outright bequests are not nearly as advantageous as using a trust, and there are various techniques discussed herein to avoid these three negatives. The best planning should probably utilize an ongoing trust ***as well as*** exploit portability, which will be discussed in the next section.

* 1. **Why not just skip the burdens of an ongoing trust?[[11]](#footnote-12) 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 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]](#footnote-13)
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 become 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]](#footnote-14) 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;[[14]](#footnote-15)
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).[[15]](#footnote-16) 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 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 ($5.49 million in 2017). The growth in a bypass trust remains outside the surviving spouse's estate. This difference can matter tremendously where the combined assets approximate $10.98 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;[[16]](#footnote-17)
8. **There is** **no DSUEA or “portability” of the GST exemption**. A couple using a bypass trust can exempt $10.9 million or more from estate/GST forever, a couple relying on portability alone can only exploit the surviving spouse’s $5.45 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 $10.9 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 $5.45 million added to that child’s estate – perhaps needlessly incurring more than $2 million in additional estate tax (potentially state as well as federal).
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.[[17]](#footnote-18) This may require opening a probate simply to appoint an executor.[[18]](#footnote-19) This is easy for non-professional executor/trustees to overlook. The IRS **may** grant exceptions or extensions of time for *reasonable cause* under Treas. Reg. §301.9100-3 **if** the estate value was under the threshold filing requirement (i.e. if no prior gifts, gross estate under $5.49 million);[[19]](#footnote-20)
10. Unlike a bypass trust, outright bequests cannot be structured to better accommodate **incapacity or government benefits (e.g. Medicaid) eligibility planning**;[[20]](#footnote-21)
11. A **bypass trust can exploit the serial marriage loophole**. Example: John Doe dies leaving his wife Jane $5.45 million in a bypass trust. She remarries and with gift-splitting can now gift $10.9 million tax-free. If husband #2 dies using no exclusion – Jane can make the DSUEA election and have up to $10.9 million Applicable Exclusion Amount (AEA), even with the $5.45 million in the bypass trust John left her, **sheltering over $16.35 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, Jane’s combined AEA would be capped at two exclusion amounts ($10.9 million, not adjusting for inflation increases, since husband #2’s DSUE replaced husband #1’s) – a potential loss of over $2 million in estate tax.[[21]](#footnote-22)
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**.[[22]](#footnote-23)

Example: John has $8 million in assets, Jane $2.9 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 $10.9 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 x 40%).

1. Tax Apportionment under §2207A and state law shafts the first to die’s children when relying on portability.

Example: John has $10.45 million, Jane has $10.45 million. John dies, leaving his assets in a QTIP for Jane to “get a second step up”, believing his kids are assured equal treatment and protection via QTIP, thus $5.45 million DSUE is ported. Jane dies with $10.9 million applicable exclusion amount (AEA), but a $20.9 million estate. This causes approximately $4 million estate tax due (or much more, depending on the state). *Guess whose kids pay all the tax?* That’s right – John, the first to die’s, kids (through John’s QTIP) pay ALL of the federal estate tax (and probably much more of any state estate tax, depending on the state), **not** half or pro-rata as some may expect.[[23]](#footnote-24) Jane’s kids, through her estate, pay none, unless she specifically overrides the state and federal apportionment statutes in her Will/trust (fat chance).

1. Bonus – The surviving spouse’s new spouse can waste all the DSUE if the surviving spouse agrees to ***gift split***. Example: John leaves $5.45 million to QTIP for wife Mary, who remarries and her new wealthy husband convinces her to split *his* $10.9 million gift. John and Mary’s children may now pay another $2 million or more estate tax at Mary’s death.

**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. The question is whether all the other downsides to this structure outweigh the benefits in light of other basis-increasing options available.

1. **Thinking Outside the “Outright 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[[24]](#footnote-25) to save the use of the exclusion via bypass trust even if the Form 706 filing to claim portability is botched.[[25]](#footnote-26) The Clayton QTIP/bypass trust combination may also save additional basis if the surviving spouse dies within 15 months.[[26]](#footnote-27)

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 same potential for fraudulent transfer, Medicaid or tax lien issues affecting disclaimants.[[27]](#footnote-28) 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.[[28]](#footnote-29) However, Clayton QTIP arrangements are best made with an independent executor, whereas the identity of the executor with disclaimers is completely irrelevant.[[29]](#footnote-30)

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 year duration) could easily decrease in value 25% if interest rates went up a couple percentage points.[[30]](#footnote-31) *Practitioners should file for a six month extension on Form 706 even if no estate tax would be due to buy additional time for basis adjustment*, even if one of the preferred Optimal Basis Increase Trust design options, discussed in Part III, is utilized.

1. **Variations in Marital Trusts – Differences between GPOA, Estate and QTIP Trusts**

Aside from the potential *state* estate tax deferral/savings, marital trusts receive a second step up in basis without sacrificing most of the protection and control of a trust. Succeeding trusts/beneficiaries generally receive a new basis when assets are in the surviving spouse’s estate, which marital trusts are.[[31]](#footnote-32) Varieties include the estate trust, general power of appointment marital trust and qualified terminal interest property (QTIP) marital trust.

An estate trust is very rarely used – it requires the spouse to be the only beneficiary and that the trust pay to the surviving spouse’s estate (but unlike other varieties, permits the trustee to accumulate income and retain property unproductive of income).[[32]](#footnote-33)

A GPOA marital trust is only slightly more protective of a settlor’s intent at the second death – it must grant the spouse the power to appoint to his/her estate without any other consenting party (a power to appoint to creditors is not enough).[[33]](#footnote-34)

The QTIP marital trust can be much more restrictive at second death than an estate or GPOA marital trust, by restricting or even omitting the surviving spouse’s power to appoint.[[34]](#footnote-35) Because of this and other advantages, QTIPs are by far the most preferred.[[35]](#footnote-36) However, especially in smaller estates of older couples with children of the same marriage, and in states with no state estate tax, ***the estate and GPOA marital trusts may see a rise in popularity*** because couples with smaller estates don’t need to file a Form 706 to get a second step up in basis and won’t get hit with additional valuation discounts hampering basis increase (discussed in next section). Additionally, GPOA marital trusts can allow tax shifting to other parties, whereas QTIP trusts cannot (see Part VIII.l herein).

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 filing. Even if *no* Form 706 is filed at the first death, assets in a GPOA marital get a new adjusted basis at the second death, even if the estate of the first spouse is still being settled.[[36]](#footnote-37)

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.[[37]](#footnote-38)

c. **Rev. Proc. 2001-38 for QTIPs Superseded by Rev. Proc. 2016-49[[38]](#footnote-39)**

Some practitioners may have turned to marital GPOA trusts for taxpayers with estates under the applicable exclusion amount because of the potential threat some had feared was posed by IRS Rev. Proc. 2001-38. Rev. Proc. 2001-38 outlined a procedure whereupon, pursuant to taxpayer petition, a prior QTIP election would be disregarded, even though the election is irrevocable, under certain circumstances. The procedure was clearly designed to help taxpayers who over-qtipped what should have remained a bypass trust where it was unnecessary to reduce estate tax. Practitioners had feared the IRS would use it as a weapon against a taxpayer’s interests, because it purportedly allowed 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.”[[39]](#footnote-40) 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 fear was always misguided (the IRS cannot simply overrule a statutory right), but thankfully the IRS confirmed this in issuing Rev. Proc. 2016-49, which supersedes Rev. Proc. 2001-38. The IRS confirmed that it will not unilaterally attempt to undo a valid QTIP election, even if it is unnecessary to reduce the estate tax.

While the updated revenue procedure is mostly welcome news, there is a new provision that shut downs any opportunity to undo the QTIP election whenever portability is elected, closing a loophole that had been left open in Rev. Proc 2001-38. This does create a potential tax *opportunity cost* for estates with QTIP trusts making portability elections.

To explain these latter points, imagine the surviving spouse dies after a “market correction”, be it the bond market, stock market, real estate market, or other, such that the second death causes a step *down*, not a step *up*. For example, the QTIP holds assets worth $3 million, with a basis of *$4 million*. The QTIP election wasn’t needed for estate or income tax purposes and, with 20/20 hindsight, isn’t desired. It was made purely on assumption that FMV would *exceed* basis by the second death. Previously, the surviving spouse’s executor could have used Rev. Proc. 2001-38 to simply “undo” the QTIP election made in the first spouse’s estate to restore the original $4 million basis and prevent the step *down*, but the new Rev. Proc. 2016-49 closes this door and only allows revisiting the QTIP election if portability were *not* elected in the first spouse to die’s estate. For spouses anticipating combined estates well under $5.49 million (now $11.18 million in 2018, $11.4 million in 2019) total, **not** electing portability after the first spouse’s death allows the QTIP election to be revisited, but this means giving up portability, which would be a hard decision for those with estates approaching one exclusion amount (or for those who fear the exclusion amount may someday decrease). Still, there is a slight downside to electing portability for small estates that is usually overlooked.

* 1. **The Estate/Basis/Valuation Advantage (for <1%), and Pitfall (for >99%) of QTIPs**

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”. At second death, these “fair market values” might total $500,000 and $300,000 respectively, rather than $600,000 and $500,000 (a 50% LLC interest would probably have a greater discount than a 50% tenancy in common interest). This effect would be exacerbated further if John and Jane owned less than 100% of the LLC, since a 49% or less interest would be typically be discounted more than 50%.

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, or through any other trust with a testamentary general power, as discussed in Part III, the two halves would be valued together for estate tax at the second death, and therefore retain full “undiscounted” basis.[[40]](#footnote-41)

**e. How to Adapt QTIPs for Better “Step Up”**

There are several solutions for the fractional interest discount issue, although many practitioners will find them odd and counterintuitive – first, use a formula general power of appointment (discussed in Part III) designed to pull such assets into the estate under IRC § 2041 *as well as* IRC §2044 to accomplish consolidation for valuation purposes. Such a power would be designed so as not to qualify the trust under IRC §2056(b)(5), yet be permitted to be retained under IRC §2056(b)(7).[[41]](#footnote-42) The public policy behind the consolidation for valuation purposes is that the surviving spouse, via GPOA, effectively controls 100% of the combined assets (whereas a QTIP often offers little if any control). There is nothing in §2056(b)(7) that precludes adding this feature, and since the assets are included in the estate anyway, there is little to be lost even under a worst-case scenario. The difficulty would lie in crafting the power to be capped or negated in the unlikely scenario that the increase in valuation due to aggregation would cause a federal or state estate tax. **For example**: Jane has a $2 million in assets of her own, $3 million in her late husband’s QTIP trust. Part of Jane’s assets is a 50% interest in an LLC that owns $2 million in property. Part of the QTIP’s assets is the other 50%. These 50% LLC interests are valued at $700,000 separately for each interest (discounted 30% from $1 million each). This discounting would be great planning if Jane had a taxable estate, but with DSUE she has $10.86 million AEA. A GPOA would aggregate the valuation at Jane’s death so as to increase the gross estate from $5 million to $5.6 million (100% of LLC should normally have little if any discount), adding $600,000 of basis. See various examples in appendix and discussion of capping GPOAs to prevent estate tax in Part III.

Would QTIP inclusion via IRC §2041(a)(3) (using a limited testamentary power of appointment to trigger the Delaware tax trap) lead to the same aggregation? While it is triggering the same statute causing estate inclusion (§2041), the same public policy argument discussed in *Fontana* and the IRS memos justifying the valuation aggregation for GPOAs is not quite the same. In short, there is a compelling argument that assets appointed under a “Delaware tax trapping” LPOA (discussed in Part III) should be aggregated with a QTIP spouse and power holder’s other assets for estate tax valuation, but it is not as certain as with “standard GPOA” assets, since there is no case law on point yet.

Adding a formula testamentary general power would also add another nine-month window for subsequent beneficiaries to disclaim after the second death (at least for the portion subject to a general power), as discussed in Part II and IV.

Second, the LLC (or Tenancy in Common) agreement can be drafted or amended to essentially remove the discounts in the right situations provided all the parties agree. In the LLC context, I call this the Optimal Basis Increase LLC.[[42]](#footnote-43) In some cases this would be necessary to optimize basis *in addition* to a general power of appointment (e.g. if the surviving spouse and spouse’s trust together did not own 100%). This would basically entail adding some of the provisions that we’ve been taught to avoid in order to achieve valuation discounts – put rights, rights to force a dissolution, rights to a pro rata portion of the total value of the entity, etc.

1. **Summarizing Benefits and Drawbacks Endemic to all Marital Trusts**

Thus, marital trust planning can combine most of the income tax basis benefit of the outright/portability option with the estate preservation and *most* of the asset protection planning advantages of a bypass trust. Marital trusts can at least partially solve the first major drawback of the bypass trust discussed above – increased basis at the second death, and can solve *most* of the baker’s dozen of drawbacks to 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, which is probably of greater concern to surviving spouses, 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 cannot be structured as third party created wholly discretionary trusts not counted as a resource or income for Medicaid or other benefit purposes. They cannot have protective forfeiture provisions like a bypass trust might. They provide greater complications for see-through trust status (aka “stretch IRAs”), especially for GPOA marital trusts, and may force out IRA distributions where none would otherwise be required.[[43]](#footnote-44) They cannot use broad *lifetime* limited powers of appointment – which can be important for gifting and income tax planning techniques discussed in Part VIII.[[44]](#footnote-45) They cannot be used by non-traditional couples who are not officially recognized as “married.”[[45]](#footnote-46) QTIPs have more onerous and complicated tax apportionment.[[46]](#footnote-47) QTIPs have more problematic issues with estate freeze, entity planning and gifting/termination due to §2519. DSUE gained through overuse of marital trusts can be lost via botched Form 706 filing, or remarriage combined with split gifts or a subsequently deceased 2nd spouse. Marital trusts have much more limited adaptability under most trust protector/amendment clauses and state decanting statutes. They risk greater “discounts” and therefore lower basis when the spouse and QTIP own fractional interests in the same property. Overuse of portability may cause the surviving spouse’s estate to go above the gross filing threshold, forcing the spouse’s estate to file Form 706 and the nasty new Form 8971 schedules with the “zero basis” problem whereas bypass trust usage in many cases may avoid that by keeping both estates under the filing threshold.[[47]](#footnote-48) Furthermore, marital trusts simply won’t be as efficient in saving state estate taxes or federal estate taxes for estates close to the state or federal applicable exclusion amount, especially if the surviving spouse lives long and assets appreciate significantly, since the DSUE amount is not indexed for inflation.

1. **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;[[48]](#footnote-49)

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;[[49]](#footnote-50)

6) giving the surviving spouse a limited power to appoint that alternatively cascades to a general power to the extent not exercised.[[50]](#footnote-51)

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 collusion to avoid tax, that funds were still held only in constructive trust by the decedent and therefore must be denied inclusion/step up.[[51]](#footnote-52) Or, if the children are deemed to have made a gift, then their exclusion would be used (perhaps not a big deal) and §1014(e) may deny the step up in basis (see comparison chart in the appendix comparing various options). There may also be a deemed commutation, gift and sale for income tax purposes.[[52]](#footnote-53) 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.[[53]](#footnote-54) 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 granted the trustee.[[54]](#footnote-55) However, it merely begs the question – *if it’s worth doing later, why isn’t it worth doing* ***now*** *before it’s too late*?

Granting the ability for a trust protector to add GPOA basis savings clauses later without *actually* adding it 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. Why not install the seat belt and air bag? Would an attorney a decade ago have told wealthy married clients to just “skip the AB trust provision, we’ll include a trust protector provision to add it in later?” Why not add the safety net now and allow it to be amended if it can later be improved?

1. **Are Trust Protector Powers to Add General Powers of Appointment *Dangerous*?**

Distinguished attorneys 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.)[[55]](#footnote-56) The worry is that this may be deemed to create a current general power of appointment over the entire trust in itself. Consider this theorem: 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.[[56]](#footnote-57) Is this so different from a non-adverse party (trust protector) being able to grant a spouse a GPOA? Both variations allow a GPOA to be exercised only with the consent of the spouse and trust protector who is non-adverse. Could this be merely a semantic difference as some warn?

I would argue this is not substantially different from an independent, non-adverse trustee with the sole discretion to pay the entire amount of a trust to a spouse or other beneficiary, or a non-beneficiary holding a lifetime limited power of appointment enabling the same. No one argues that these longstanding powers cause a GPOA and estate inclusion, yet they are substantially the same. We don’t consider the spouse and non-adverse trustee’s powers together because the trustee has a fiduciary duty to all beneficiaries, including remaindermen. When we look at it this way, we probably see some absurdity and conclude such trust protector powers cannot create a GPOA in people by the mere power to add a GPOA later – else the IRS would have long since hammered thousands of trusts with estate inclusion. However, it may matter if the trust protector or other advisor is not considered a fiduciary and held to no fiduciary duties in his or her ability to add a GPOA. Some attorneys will draft, and some state laws will allow, trust protectors/advisors to be considered *non-fiduciaries*. If so drafted, such clauses may be riskier, because they are more truly analogous to a spouse and *non-adverse* party jointly controlling a general power of appointment.

To summarize, while it is not a strong argument, why tempt it? If you allow a trust protector or other party to grant or amend a beneficiary’s GPOA, especially if the party is not considered a fiduciary, consider capping and limiting the scope of the GPOA the trust protector/advisor may add (as discussed in the following Part III and in Appendix).

The third technique, using a limited lifetime power of appointment (aka collateral power), 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 obstinacy 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.[[57]](#footnote-58)* You need not reopen a probate estate to appoint an executor, the trustee may file.[[58]](#footnote-59) 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.[[59]](#footnote-60) 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 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).

1. **Introducing the Targeted Formula GPOA Concept**

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 would be much less. After 8 years, when she dies, these trust assets have grown to $4 million, as follows:

Traditional deductible IRA[[60]](#footnote-61) 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[[61]](#footnote-62) basis $200,000, FMV $600,000

Various stocks that have increased in value basis $400,000, FMV $900,000

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.[[62]](#footnote-63) 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.

Step up caused by formula

GPOA or LPOA and §2041(a)(3)

1. **Comparing the Effect of OBIT v. QTIP v. Bypass**

**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 Pollyanna-ish 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)?

1. **Capping the GPOA to Avoid State and/or Federal Estate Tax**

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.[[63]](#footnote-64) All of our traditional planning has A/B/C, GST formulas that the IRS has blessed and this should be no different.[[64]](#footnote-65) 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 optimal ordering formula and adjusting for state estate taxes.

1. **Determining the Appointive Assets When the GPOA is Capped**

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 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 rental 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 familiar 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.[[65]](#footnote-66) 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.[[66]](#footnote-67) By contrast, a trustee should recognize no gain or loss on a distribution in satisfaction of a specific appointment if the fiduciary delivers to the beneficiary the exact property described in appointment – the basis, stepped up to date of death or alternate valuation date value, should carry over accordingly.[[67]](#footnote-68)

Thus, we should avoid simple powers of appointment over, for example, “the maximum amount of assets that would not cause my spouse’s estate to incur state or federal estate or generation skipping transfer tax” – even though this may not be a problem in many cases, and usually far superior to doing nothing.

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.[[68]](#footnote-69) 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.

**Trustee Choice v. Ordering Rule**

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*.”[[69]](#footnote-70) 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.[[70]](#footnote-71)

While this is fundamentally different in some ways from AB funding formulas that involve trustee choice, the IRS may try to apply a “fairly representative” requirement anyway.[[71]](#footnote-72) Moreover, because the power does not apply to specific assets at death, it may be seen as a fulfillment of a pecuniary amount, rather than a power over specific assets, with attendant post-mortem gain triggering issues discussed above. Arguably the power holder’s *GENERAL* power, once curtailed by the trustee’s fiduciary limited power, is only over specific assets chosen by the trustee. But I would not count on an IRS agent understanding this.

Moreover, what if the beneficiary does not exercise the GPOA? This would be quite common. Would the IRS try to ignore the trustee’s choice as moot except for the tax effect and attempt to disregard it, since the trustee’s “choice” has no effect on where the assets go or how they are administered?[[72]](#footnote-73) It’s not a strong argument. All in all, 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 trustee’s discretionary choice.

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).[[73]](#footnote-74) This means a basis increase from $200,000 to $533,333. This method could easily make for a rather extensive spreadsheet when dealing with dozens if not hundreds of individual stock positions, but it’s less burdensome than what 2010 executors had to deal with for carryover basis, and is not much of an issue with modern spreadsheets.

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.).[[74]](#footnote-75) 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 some flexibility over the trustee power noted above, it is probably the more conservative route.

**Income Tax Certainty by Forcing a Form 706 Filing for the Power Holder’s Estate**

Some argue that a formula GPOA, if the appointive assets are large enough to trigger a cap, triggers a Form 706 filing and additional estate expense. This is true, because even with a zero-tax formula, the gross estate before will always be larger than applicable exclusion. The requirement to file an estate tax return is based on the gross estate, not the net.[[75]](#footnote-76) This is actually a significant tax *benefit*. The reason is that, when a Form 706 is required to be filed, the IRS is locked into the basis of hard to value assets for subsequent income tax purposes:[[76]](#footnote-77)

(a) Fair market value. For purposes of this section and § 1.1014-1, the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its fair market value. If no estate tax return is required to be filed under section 6018 (or under section 821 or 864 of the Internal Revenue Code of 1939), the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable.

This helps to ensure certainty for later depreciation and capital gains calculations, not only for the appointed assets, but the power holder’s other estate assets as well.

1. **Issues if the Spouse is Sole Trustee or Investment Advisor**

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.[[77]](#footnote-78) There is a longstanding duty of impartiality imposed on trustees.[[78]](#footnote-79) Thankfully, there is a 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.”[[79]](#footnote-80)

Still, this may be one more reason for a conservative practitioner to use an independent trustee, co-trustee and/or investment trustee. There are important side benefits to this – better asset protection when a current beneficiary is not sole trustee, protecting the surviving spouse from breach of fiduciary duty charges from remaindermen for bad investment decisions, or protecting the family from such mismanagement in the first place.[[80]](#footnote-81)

If such a design is still undesirable, consider 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 over only specific assets, 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.

1. **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.[[81]](#footnote-82) Consider the extremes: we do not want to grant a GPOA over stock bought at $95 rising to $100 at date of powerholder’s death to save $1 or so in potential capital gains tax savings if the state estate tax incurred on the $100 is $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, since it would not cause any additional state estate tax.[[82]](#footnote-83)

Conversely, assets with a lot of gain may benefit from an increase despite any state estate tax. With the exception of Washington state, 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 or 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 applicable 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.

Practitioners may want to modify their formula 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.[[83]](#footnote-84)

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.

1. **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.[[84]](#footnote-85) 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”.[[85]](#footnote-86) 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].[[86]](#footnote-87) My beneficiary also may appoint to creditors of his or her estate.”[[87]](#footnote-88)

Furthermore, a power is still a GPOA if it may only be exercised with the consent of a non-adverse party.[[88]](#footnote-89) Who is “adverse”? Generally, it is someone with a present or future chance to obtain a substantial personal benefit from the property – not all beneficiaries would always be adverse.[[89]](#footnote-90) 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![[90]](#footnote-91)

Surprisingly, even a trustee with fiduciary duties to beneficiaries who would clearly be adverse is not considered adverse itself.[[91]](#footnote-92) 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 [or trust protector].” Courts generally uphold such preconditions on exercise.[[92]](#footnote-93) It is unclear whether a beneficiary/trustee would be adverse – for planning purposes, assume it could be either. Therefore, if you name a trustee as an intended non-adverse consenting party, then 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.

Even more surprising is that requiring consent of a *probate court* to exercise a power may be treated similarly to consent of a non-adverse, independent trustee.[[93]](#footnote-94) In *Picciano*, the decedent was required to obtain a probate court's consent before selling or conveying the property left to her by her late husband over which she effectively had a power of appointment. Citing and comparing *Towle (cited above)* and numerous other cases, the *Picciano* court found that the “Probate Court had no "interest" in the property passing under the Bunnell will because that Court could in no way benefit from that property. It could be said that the Clermont County Probate Court stood as a trustee, but as such it did not stand in the place of the remaindermen such that it had an interest adverse to that of the deceased.”[[94]](#footnote-95) Thus, *even requiring probate court approval to exercise a testamentary power does not negate a general power of appointment*.

Furthermore, a general power of appointment is “considered to exist on the date of a decedent's death even though the exercise of the power is subject to the precedent giving of notice, or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the decedent's death notice has been given or the power has been exercised.”[[95]](#footnote-96) 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).[[96]](#footnote-97) Although the OBIT techniques herein to increase basis would not apply to IRAs or qualified plans,[[97]](#footnote-98) 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 treatise, 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.[[98]](#footnote-99)

In addition, any “consent” provision should ensure that there are backups and defaults to ensure that there is consenting party with a bona fide ability to ratify any appointments at the time of death or shortly thereafter.[[99]](#footnote-100) 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 even be a trustee). For example, if there is no way the "consenter" COULD consent (e.g., if dead), and the default in its absence were to deny the appointment, then there is probably no general power under §2041. If the “consenting party” is under a legal disability, the IRS has an argument (albeit weak, considering the precedent) that there is no GPOA, unless an agent/conservator/guardian can consent. What if the non‐adverse party renounces or disclaims their power to consent rather than simply declining, 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 in lieu of death or disclaimer/resignation/renunciation, and, of course, you can have the default be to ALLOW exercise rather than deny it in the event there is no consenting party available, or copy the *Picciano* case and provide probate court consent as backup.

For instance, a default clause might 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. One can add language to allow agent/guardian consent, and language to trigger or 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 within 30 days, or draft it as a veto power. In short, you can ensure the capability of exercise is always there and effective under clear tax statute and precedent, even if the practical likelihood of both a power holder and consenting parties agreeing to appoint to creditors would be extraordinarily unlikely (see clauses in appendix).

1. **Could testamentary GPOA assets be subject to creditors of an insolvent powerholder’s estate, or subject to state spousal elective share statutes?**

While only a handful of states have specific state law impacting creditor access to testamentary GPOAs, common 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. [[100]](#footnote-101) In bankruptcy the assets are generally **not** subject to creditors, but this may turn on state law or lead to another conclusion if a debtor dies during the bankruptcy.[[101]](#footnote-102) A creditor’s access may depend on whether the power is *exercised* or whether it is merely allowed to lapse.

Here are three sources with the general rules. The third citation is from an attempt by the National Conference of Commissioners on Uniform State Laws (NCCUSL) to steer state law towards a more creditor-friendly position.[[102]](#footnote-103)

*§ 13.2 Creditors of the Donee --* ***Unexercised*** *General Power Not Created by Donee.*

Appointive assets covered by an unexercised general power of appointment, created by a person other than the donee, can be subjected to payment of claims of creditors of the donee, or claims against the donee's estate, ***but only to the extent provided by statute***.[[103]](#footnote-104)

*§ 13.4 Creditors of the Donee -- General Power* ***Exercised*** *by Will.*

Appointive assets covered by an exercised general power to appoint by will, created by a person other than the donee, can be subjected to the payment of claims against the donee's estate.[[104]](#footnote-105)

***§ 502. CREDITOR CLAIM: GENERAL POWER NOT CREATED BY POWERHOLDER.***

(a) Except as otherwise provided in subsection (b), appointive property subject to a general power of appointment created by a person other than the powerholder is subject to a claim of a creditor of: \*\*\*\*(2) the powerholder’s estate, to the extent the estate is insufficient, subject to the right of a decedent to direct the source from which liabilities are paid. [subsection (b) refers to HEMS standards, i.e., nongeneral powers][[105]](#footnote-106)

Surprisingly, the Uniform Probate Code also seems protective of testamentary GPOAs as against non-spousal creditors.[[106]](#footnote-107) If your state law is unfavorable to debtor/decedents holding testamentary GPOAs, like California, some may find it preferable to use the Delaware Tax Trap (DTT) technique if there is a fear that a power holder’s estate may be exposed to significant lawsuits or insolvency. The DTT technique uses *limited* powers of appointment only. Alternatively, one can simply *limit the testamentary GPOA should the powerholder’s estate be insolvent*.[[107]](#footnote-108)

In many other states, a specific statute, like the Rhode Island or Alaska statutes cited above, may give comfort.

Most states probably currently follow the common law elucidated by §13.2 of the 2nd Restatement cited above, which gives protection to insolvent power holder estates where the power remains unexercised.[[108]](#footnote-109) But three concerns may still arise even for these states:

1) The state may subsequently pass the Uniform Power of Appointment Act (UPAA). If your state is debating the UPAA, it may be an opportunity to amend §502 prior to passage, as many states did with various provisions of the Uniform Trust Code. Colorado, e.g., *omitted the entire Article concerning creditor rights*.[[109]](#footnote-110) Utah amended its version of §502.[[110]](#footnote-111)

From a practical and public policy standpoint, a testamentary general power is quite different from outright ownership, especially if there are various limitations and constraints on the power, such as non-adverse party consent requirements, as discussed herein.

1. Which state law applies and what if the donor and donee of the power are in different states? What if the donee power holder changes state of residency? For instance, from Rhode Island to California. Which state’s debtor/creditor law applies to the power of appointment, the donor or the donee of the power? The new UPAA attempts to change the common law in this regard. At common law, the applicable law of the donor applied, but under the UPAA, the applicable law of the state of the donee power holder will apply, but the UPAA may not necessarily apply to both states. Can this be changed? Can we import or declare a particular state law to apply and would it hold up as against creditors? No one wants a messy conflict of law or federal dispute if it can be avoided. If California creditors come after a trust merely because a powerholder resided there, can they even get jurisdiction over a trustee in another state? Perhaps not - where are the minimum contacts?
2. What if the power holder actually *exercises* the power? Even if it is exercised in favor of non-creditor appointees, such as children or charities, this may trigger the application of the common law rule in Restatement Second §13.4 discussed above. There are various instances where a power holder will not just want a power to lapse, but exercise it - either for dispositive reasons, asset protection reasons or even to change grantor trust status.[[111]](#footnote-112)

Since future law is always uncertain, as well as the residency of the powerholder, and whether the powerholder might exercise, it may be prudent to take several steps to mitigate against these risks when drafting testamentary GPOAs:

1. Allow a trustee or trust protector to amend according to changes in circumstance (as discussed elsewhere herein, see sample clauses outlining reasons).
2. Limit the scope of the power by creating a prerequisite, cap or threshold preventing GPOAs for substantially insolvent estates. By “substantially insolvent”, if the power holder’s estate is insolvent by $10, such that a creditor could seize only $10 of assets subject to the power holder’s GPOA, would you want to void the GPOA entirely, forgoing up to $5.34 million of basis to thwart a $10 debt? I suggest preventing a GPOA only where the cost outweighs the benefit.[[112]](#footnote-113) The clause might only be activated if UPAA §502, Ca. Prob. Code §682(b) or equivalent is applicable. Solvency is a valid condition precedent to vesting interests.[[113]](#footnote-114)
3. Draft limited and general powers separately, so that the GPOA does not allow appointment to anyone but creditors. Would exercising a limited power to appoint to children/trust be deemed an exercise of a GPOA under state law where a concurrent GPOA exists? I am uncertain as to the answer – the exercise of an LPOA when a GPOA also exists may be deemed to be an exercise of the GPOA even if they are in separate paragraphs, but it can’t hurt to separate into two powers.
4. Require consent of a non-adverse party or parties to enable exercise of a GPOA, being careful to have successor “consenters” in the event that person dies or is incapacitated, else state law may deem consent to be unnecessary, or possibly worse (depending on trust terms), that there is no general power at all.[[114]](#footnote-115)

If the general testamentary power has already been drafted and the powerholder anticipates having an insolvent estate at death due to substantial creditors at the gate, and is worried about appointive assets being accessed by creditors at his or her death, because they live in a state like California or plan to exercise the power and live in a state that would subject appointed assets to creditors, they may be able to either release the power before death, elect not to exercise the power (if that is how the state would attack it), amend the power pursuant to the document and/or state law, or *simply file bankruptcy prior to death, if the debt is dischargeable*. *Testamentary* general powers are excluded from a power holder’s bankruptcy estate.[[115]](#footnote-116)

**Spousal Elective Share Rights**

Some may fear that third party-created formula testamentary GPOAs risk invoking spousal statutory share rights should the surviving spouse remarry (or, in the event another beneficiary has a similar testamentary GPOA and is married). This is not the case for the vast supermajority of states.[[116]](#footnote-117)

While it’s probably not an issue unless you live in Delaware, you might circumscribe the formula GPOA to prevent application if the powerholder were to move to Delaware of a state that later enacts a new statute that includes third-party created testamentary GPOAs. Some might simply ignore this in drafting the formula GPOA as currently a “non-issue”, but note the settlor’s concern about future legislation expanding the spousal elective share in any statement of material purpose or trust protector or amendment clause that outlines the scope of potential future amendments, such as the example in the appendix.

**Effect of Formula Testamentary GPOAs on Prenuptial and Postnuptial Agreements**

While you may be able to avoid third party creditor issues either by residing outside of CA, not exercising the GPOA, or through drafting, and spousal elective share statutes are unlikely the issue some think it is, you should still examine any pre/post nuptial agreements or contracts to make a will that might affect property rights/division based on a contracting party’s “*taxable estate”,* which could conceivably be overly broadly defined so as to include such assets. A pre or post nuptial agreement might easily have a much broader definition of estate than a state spousal elective share statute. For example, what if a pre/post nuptial agreement provides that a spouse is to receive 1/3 of the other spouse’s taxable estate and their parent (or child or some other settlor as contemplated in Part V) has granted that spouse a formula testamentary general power of appointment? A well-drafted contract would probably exclude such assets, but it merits careful examination nonetheless.

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

There is a technique to accomplish the same result as a formula general testamentary power of appointment using a *limited* testamentary power of appointment that is treated as a general power of appointment for federal tax purposes. This involves IRC §2041(a)(3), colloquially known as the Delaware Tax Trap (“DTT”):[[117]](#footnote-118)

“(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 federal estate/gift tax rule, in conjunction with various states’ rules against perpetuities, is complex. The following is an example of a state rule against perpetuities, which may cause flashbacks in some readers to first year property law course:

“An interest is not good unless it must vest, if at all, no later than twenty-one years after some life in being at the time of the creation of the interests, plus a period of gestation.”[[118]](#footnote-119)

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 easiest method of triggering §2041(a)(3) which is the most likely to be available in the vast super-majority of states under common law or the uniform act.[[119]](#footnote-120)

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 (often 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.[[120]](#footnote-121)

The reason that appointing to a trust that grants an intervivos general power of appointment is different than appointing to other trusts (including ones with limited powers of appointment) is that for purposes of the rule against perpetuities, a general powerholder’s exercise would start a new perpetuities period – it is measured from the date of exercise, rather than from the original creation of the power.[[121]](#footnote-122) This in turn triggers IRC §2041(a)(3).

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 (“DTT Trust”) discussed above, and other assets outright or to another ordinary trust. Treasury Regulations outline examples of targeted use of the Delaware Tax Trap (“DTT”) as this paper 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).”[[122]](#footnote-123)

Similarly, $25,000 of low basis stock could be appointed to the DTT trust, and $75,000 of high basis stock could be appointed outright or to an ordinary trust. In drafting mode, using the DTT is probably *not* 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. Further, it does not allow for avoidance of state or federal estate taxation or avoidance of a step down in basis at the child’s death.[[123]](#footnote-124)

With all of the above negatives, using the DTT to harvest the basis-increasing 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.

Just because the Rule Against Perpetuities is complex to understand, does not mean that an attorney or other advisor cannot be held liable in malpractice for failure to recognize a beneficial opportunity to trigger the Delaware Tax Trap for additional income tax savings, or for accidentally causing additional estate/GST tax. However, at least one state supreme court has found that the Rule Against Perpetuities is so complex and perplexing that it is beyond the skills of an ordinary attorney![[124]](#footnote-125)

1. **Drafting Alternatives to Curb the “PEG Power” yet still trigger §2041(a)(3)**

Practitioners might even craft a lapsing “*Crummey*” power into the appointive trust so that the power lapses. Depending on the state, it may still be protected, either in full or to the extent the lapse does not exceed 5% of the trust.[[125]](#footnote-126) If state law applicable to the beneficiary and trust is not protective, upon lapse/expiration of the power, the assets might flow into a self-settled, incomplete gift domestic asset protection trust (DAPT) with situs in Ohio, Delaware or one of the other more than a dozen states which now permit this. Alternatively, as with *Crummey* powers, a portion may “hang,” to avoid any completed gift by the lapse, yet may still be protected in UTC states provided that the hanging power can only be exercised with the consent of a non-adverse trustee.[[126]](#footnote-127)

In the event a lapsing PEG power is granted to a spouse, this would not disqualify the trust for the marital estate tax deduction, but only if the trust otherwise qualifies in the event the power lapses (such as retention of a testamentary power or QTIP).[[127]](#footnote-128) It may also be possible to use the 5% lapse protection to gradually reduce the amount of the trust included in the PEG powerholder’s estate over time.[[128]](#footnote-129)

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 the******remainder interest.***This is still deemed a “presently exercisable” GPOA.[[129]](#footnote-130) 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 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.”[[130]](#footnote-131)

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. Such an appointment would be rare, however, since LPOAs usually *exclude* subsequent spouses as potential appointees, but it is certainly possible, especially in a trust for children where a parent may want some limited flexibility not to impoverish their son or daughter in law. In such 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 or even using a dime of applicable exclusion amount.

What if the PEG power required non-adverse party consent? Would this preclude such a restricted and protective PEG power from being “presently exercisable” and triggering the DTT? *Probably not* – all that §2041(a)(3) requires is that the power *“can be”* exercised to start a new rule against perpetuities period. There is no mention, as elsewhere in the code, of such power needing to be unfettered. The important question is whether such a PEG power would be treated the same way for purposes of the state law around its Rule Against Perpetuities. In most cases, it probably would. Let’s examine Ohio’s statute, which was meant to be a codification of common law on this point, and explain why:[[131]](#footnote-132)

(D) For purposes of this section and subject to sections 1746.14, 1747.09, and 2131.09 of the Revised Code, the following apply:

(1) The time of the creation of an interest in real or personal property resulting from the exercise of a general power of appointment exercisable in a nonfiduciary capacity by deed, whether or not also exercisable by will, shall be the time at which that power of appointment is exercised.

(2) The time of the creation of an interest in real or personal property resulting from the termination, without exercise, of a general power of appointment exercisable in a nonfiduciary capacity by deed, whether or not also exercisable by will, shall be the time at which that power of appointment terminates by reason of the death of the power holder, by release of the power, or otherwise.

General power of appointment is later defined under Ohio law as:

(1) "General power of appointment" means a power that is exercisable in favor of the individual possessing the power, the individual's estate, the individual's creditors, or the creditors of the individual's estate other than either of the following:

(a) A power that is limited by an ascertainable standard as defined in section 5801.01 of the Revised Code;

(b) A power of withdrawal held by an individual, but only to the extent that it does not exceed the amount specified in section 2041(b)(2) or 2514(e) of the "Internal Revenue Code of 1986," 100 Stat. 2085, 26 U.S.C. 1 et seq., as amended.[[132]](#footnote-133)

Thus, because a power of appointment only exercisable with consent of a non-adverse party is still “general” under state law, and because state law considers the interests created by the exercise or lapse/release of such a power to create a new property interest and start a new rule against perpetuities, requiring consent of a non-adverse party to exercise the PEG power should have no effect for triggering the Delaware tax trap under §2041(a)(3). In fact, under Ohio’s definition above, even required consent of ***adverse*** parties would have the same result! Whether your state considers a PEG power to appoint only with consent of *adverse* parties to be *general* is dependent on whether it follows the 2nd or the 3d Restatement.[[133]](#footnote-134)

Thus, we have a counterintuitive situation where a PEG power that is not a general power of appointment under IRC §2514 is still a general power for triggering the DTT. It depends on the state, but in most states, such a circumscribed power is ***not*** attachable by creditors as a standard withdrawal power would be.[[134]](#footnote-135)

An additional benefit of using a consenting party for the PEG power is that it enables the subsequent trust to avoid grantor trust status as to the PEG power holder under §678(a)(discussed in Part V and Part VIII), which may enable more tax shifting and avoidance of state income tax (depending on trust residency statutes and source income).

Nonetheless, a formula GPOA would still be more advantageous than using the PEG/DTT in the long run, because of better estate/gift/GST sheltering, and possibly superior third party settled trust protection. However, using the PEG/DTT mitigation techniques above can offer substantial protections and advantages. Ideally, states will amend their Rule Against Perpetuities statutes to permit opting into a regime that would allow LPOAs creating further LPOAs to trigger the DTT, obviating the need to use PEG powers in the appointive trust.[[135]](#footnote-136)

1. **Amending or Crafting Delaware Tax Trap Savings Clauses**

Practitioners may legitimately fear that the Delaware tax trap might be triggered accidentally, over assets that would get a step down in basis, or worse, over so many assets that additional estate tax is caused. The latter, of course, has been the main concern historically. This is why most states have closed the loophole and foreclosed the possibility of the DTT applying, except in the case of appointing to a trust with a PEG power. Some trust documents attempt to close the DTT altogether, including what the states would otherwise allow, so that any attempted appointment triggering the DTT would be null and void (a.k.a. “a fraud upon the power”). Here is one example:

"My beneficiary may not exercise this testamentary limited power of appointment to create another power of appointment that, under the applicable local law, can be validly exercised in order to postpone the vesting of any estate or interest in this property for a period ascertainable without regard to the date of the creation of the first power.”

This prevents using an LPOA to appoint to a trust with a PEG power. However, we should not completely foreclose the use of the DTT in our trusts. It’s like using a sledgehammer to swat a fly. We should merely prevent the *inadvertent exercise* that triggers estate tax (or more estate tax than is saved in income tax). Therefore, we could modify the above savings clause with something like:

“*Unless my beneficiary specifically indicates an intention to override this paragraph* or for IRC §2041(a)(3) to apply to his or her exercise of the testamentary power of appointment granted herein, ….”

This requires an affirmative opting in by the power holder. Of course, you could also add a cap to this power, and a limitation on appointive assets subject to it, but a basic specific opt-in should be adequate protection. Limitations beyond this may be detrimental – as discussed above, there may be cases where triggering a small state estate tax is worth it to get a larger overall income tax benefit, or, Congress may one day lower the estate tax rate or even repeal the estate tax.

1. **Addressing the *Kurz* case and other Potential Attacks 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 granting her 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.[[136]](#footnote-137) Strangely, it seems the same commentators that laud or even use the technique for GST planning for the wealthy seem to disparage the idea for income tax planning for the mere *upper-middle class*.

What about trust protector provisions that allow adding/amending POAs? Could this ability somehow taint the tax effectiveness of the formula GPOA? Probably not, since POAs are deemed general or non-general based on their scope at the applicable time in question.[[137]](#footnote-138) As previously discussed, the problem with these is more practical – they may never get used!

1. **PLRs 9110054, 9527024 – Approval of Formula GPOAs to Optimize GST/Estate Tax**

The IRS has viewed very similar and arguably more complex formula GPOAs favorably. Unlike some PLRs, these appear to be on steady ground based on the regulations they cite. Although these clauses were used to cause estate taxation in lieu of GST taxation, the concept and issues are precisely the same. Let’s examine PLR 9527024 first:

“In addition, under Article IV-D-3 of the trust, a child who has a power of appointment exercisable by will may, by a will specifically referring to this power of appointment, appoint to his or her estate **to the extent the aggregate of the federal estate and GST tax due as a result of the child's death can be reduced. The amount of property subject to the power will be includible in the child's gross estate under §2041. To the extent the property is includible in the child's gross estate and subject to federal estate tax, the child will become the transferor of the property for GST purposes**.

Accordingly, as a result of Article IV-D-3, no GST tax will be due at a child's death (assuming that the child does not appoint the property to a skip person) unless and until the marginal rate of federal estate tax in the child's estate equals the GST tax rate (the maximum federal estate tax rate). The trust will not be subject to federal estate tax in the child's estate except to the extent inclusion of the property results in a reduction of the aggregate taxes.”[[138]](#footnote-139)

Like an OBIT clause, the efficacy and administration of this PLR’s GPOA depends and is blatantly relying on the power holder’s *outside assets, estate plan and applicable exclusions*.

PLR 9110054 has a similar formula GPOA, but is even more complex because the taxpayers were in California, which, as discussed in Section III.h. above, subjects testamentary GPOAs to the power holder’s estate’s creditors to the extent the estate is insolvent (hence the second paragraph quoted below). The pertinent discussion of the formula GPOA sanctioned in that PLR is below, with bold and bracketed language added:

“Under paragraph 7.3.3, in the event that the beneficiary of a Non-GSTT trust predeceases the full distribution of the trust estate, the beneficiary will have the power to appoint ("the Power") in favor of one or more of the creditors of the beneficiary and/or the creditors of the beneficiary's estate so much of the trust estate that may be undistributed at the time of the beneficiary's death as: (1) would otherwise be distributed to a "skip person" as defined in section 2613 of the Internal Revenue Code, with respect to X; and (2) **does not exceed the Appointment Amount**.

Under paragraph 7.3.3.1 of the X Trust, the Appointment Amount is defined as the amount which is **the lesser of** (1) the portion of the trust estate which is not exempt from generation-skipping transfer tax or (2) **an amount which, when added to the beneficiary's taxable estate (computed as if the Power had not been granted based upon values of the beneficiary's estate), will cause one dollar ($1.00) to be subject to federal estate tax in the beneficiary's estate at the highest tax rate** then in effect as set forth in section 2001 of the Internal Revenue Code.

The X Trust also provides that, **in the event that the liabilities of the beneficiary's estate exceed the value of its assets** (based upon values as finally determined in the federal estate tax proceedings of the beneficiary's estate excluding the Power), **no Power is granted** **unless** the sum of (i) the federal estate taxes and state inheritance or estate taxes which would be payable by reason of the beneficiary's death computed as if the property appointable by the power had been included in the beneficiary's gross estate, (ii) the GSTT which would be payable from the trust by reason of the beneficiary's death computed as if the property appointable by the Power has been included in the beneficiary's gross estate for federal estate tax purposes, and (iii) **the excess of the liabilities of the beneficiary's estate over its assets**, excluding the Power shall be less than or equal to the GSTT which would be payable from this trust by reason of the beneficiary's death computed as if the Power had not been granted.

California Civil Code section 1390-3(b) *[note – this statute is the direct predecessor to California Probate Code §682, with similar import, discussed in Section III.h.]* enables the creditors of the insolvent estate of a donee of a general power of appointment to reach the assets subject to such power. According to the taxpayer, the second part of the formula which calculates the extent of the X Trust over which the Power may be exercised **is intended to nullify the Power** if the net trust estate without the Power after payment of the GSTT, will exceed the net trust estate if the Power is granted to an insolvent donee, after reduction of estate taxes and payment of creditors.

**Even though the power is expressed in terms of a formula, the power meets the statutory definition of a general power of appointment** because it is exercisable by the beneficiary alone in favor of one or more of the creditors of the beneficiary or the creditors of the beneficiary's estate, and the power is not limited by an ascertainable standard. **We conclude therefore, that the power created by X under paragraph 7.3.3 of the X Trust is a general power of appointment within the meaning of section 2041(b) of the Code**.

Under section 20.2041-3(b) of the regulations, a power which by its terms is exercisable only upon the occurrence of an event or contingency which does not in fact take place prior to the decedent's death is not a power in existence on the date of death. [*note, this is the regulation interpreted by the Kurz cases discussed in Section III.n. below, and cited by some as a worry about formula GPOAs*]

In the present case, **the power of appointment is expressed as a formula**:\*\*\*

**Under this formula there are contingencies that may result in the nonexistence of the Power upon the date of the beneficiary's death. If these contingencies do occur,** that is, if the liabilities of a beneficiary's estate exceed the value of its assets and the taxes that would be payable if the Power had not been granted are less than if the Power had been granted, **the Power will not be granted. In such a case, the beneficiary *will not possess a power of appointment* at the time of death.**

**Although we do not know at this time whether the beneficiary will possess a general power of appointment at the time of the beneficiary's death,** **we can conclude that the amount of the X Trust property that will be includible in the estate** of each donee of the Power, **by reason of the Power will be the maximum amount over which the Power may be exercised pursuant to the provisions set forth above** that are provided in Paragraph 7.3.3 and 7.3.3.1 of the X Trust.

PLR 9110054 is a rather clever formula GPOA that both minimizes the GST and estate tax when considered together, but also *does not add a GPOA if it would otherwise jeopardize the power holder’s estate to creditors*. The OBIT is in many ways an expansion on these formula GPOAs, but expanded to apply beyond GST non-exempt trusts for superior *income* tax results. While the thrust of this white paper has been spouses and GST exempt trusts, the GST language in the trusts in the PLRs above might be considered in creating formula GPOAs for downstream beneficiaries, and, of course, any GPOAs over GST non-exempt trusts.

Three additional PLRs since these two implicitly approved of formula GPOAs.[[139]](#footnote-140) In PLR 2004-03094, the trust in question had this formula general power of appointment:

“Article 4.5 provides: At my wife’s death, if I am still living, I give to my wife a testamentary general power of appointment, exercisable alone and in all events to appoint part of the assets of the Trust Estate, having a value equal to (i) the amount of my wife’s remaining applicable exclusion amount less (ii) the value of my wife’s taxable estate determined by excluding the amount of those assets subject to this power, free of trust to my deceased wife’s estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my wife may direct in her Will.”

Uniquely, the PLR also contains the wife’s will provision that would purportedly exercise the power in favor of her estate, although this should not make any difference for the taxability of the power. The IRS in that PLR concluded that:

“Under article 4.5 of Trust, if Wife predeceases Husband, at her death Wife will possess a testamentary general power to appoint to Wife’s estate or to or for the benefit of one or more persons or entities, Trust assets equal in value to Wife’s remaining applicable exclusion amount less the value of Wife’s taxable estate determined as if she did not possess this power. Accordingly, we conclude that, if Wife predeceases Husband, **the value of Trust assets over which Wife holds a power of appointment under article 4.5 of Trust will be included in Wife’s gross estate**.

In PLR 2006-04028, which was similar in many ways to the above 2004 PLR, the trust contained a similar provision:

“In addition, Trust 1 provides that if Wife is living at the time of Husband’s death, Husband shall have a testamentary general power of appointment equal to the amount of Husband’s remaining applicable exclusion amount set forth in § 2010 of the Internal Revenue Code (“Code”) minus the value of Husband’s taxable estate (determined by excluding the amount of those assets subject to this power).”

The IRS concluded that:

“Under the terms of Trust 1, as amended, if Husband predeceases Wife, Husband will possess a testamentary general power of appointment over assets equal in value to Husband's remaining applicable exclusion amount less the value of Husband’s taxable estate determined as if he did not possess this power. Accordingly, we conclude that, if Husband predeceases Wife, the value of Trust 1 assets over which Husband holds a testamentary general power of appointment will be included in Husband’s gross estate.”

The most recent PLR did not involve a spousal cross-GPOA (aka JEST), but involved adding a general power to an old irrevocable trust.[[140]](#footnote-141) As cited elsewhere herein, Treasury has given examples of tax minimizing formula clauses in the QTIP and disclaimer realm, and regulations under §2041 and §2514 are clear in the ability to cap or limit GPOAs as to specific assets. However, there is some plausibility and a case that on the surface appears to cast doubt on whether there may be an issue if a powerholder may indirectly affect the scope of their power, so let’s distinguish the case, discuss why the “ballooning GPOA” argument has no merit, and how to easily avoid it anyway.

1. **Addressing the *Kurz* Cases Regarding *Contingent* GPOAs**

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. [[141]](#footnote-142) 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:

“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 – not so different from a revocable trust. 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 – it’s testamentary. 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.[[142]](#footnote-143) 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 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*.[[143]](#footnote-144) 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 plausible interpretation would she have the power to give $11.5 million to that class of appointees that creates a *general* power.

Other detractors of formula powers argue that various expenses and deductions that might delay the determination of the value of the appointive assets make a formula GPOA “indeterminable” and, therefore, null and void. Could Bill Gates leave a fortune to his wife Melinda in a GPOA marital trust and her estate later simply claim that the amount is “indeterminable” at the date of death because of the alternate valuation date, expenses, debts, various tax election choices or any number of issues that will ultimately determine the net value of appointive assets subject to the GPOA? Good luck with that argument!

QTIP regulations specifically permit formula elections that refer to the taxable estate, *even though later actions by a trustee/executor clearly affect the ultimate amount passing to the QTIP*![[144]](#footnote-145) OBIT formulas are similar to disclaimer and QTIP formulas in the regulations.

Despite the above analysis, many practitioners would prefer avoiding even the hint of a *Kurz* type argument against formula GPOA caps, and any argument that the powerholder controls the amount directly or indirectly. First, avoid calling your clause a contingent GPOA, to avoid tempting an inapt comparison of a formula clause over specific assets to the completely different concept/regulation of contingent GPOAs analyzed in the *Kurz* cases.[[145]](#footnote-146) Second, draft the formula GPOA to avoid considering any marital/charitable bequest by a power holder, even if it might in rare cases reduce the amount that might be included in a power holder’s appointive assets and potentially reduce the step up. While the formula GPOA the IRS approved in PLR 9527024 contained no such limitations or restrictions, 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 clearer positive precedent.[[146]](#footnote-147) *In most estate plans, this is unlikely to make much, if any, difference, so why take a chance, even if it’s remote risk*?

Other methods are simply to periodically revisit the power through an independent trustee or trust protector power to amend to adjust to circumstance, or base the cap on an estimated likely estate size (building in a cushion for growth) and simply subtract that from the applicable exclusion amount in place at the time of death.

Some may also fear some kind of public policy argument similar to the gift tax formula valuation adjustment cases and rulings.[[147]](#footnote-148) 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 and 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). Therefore, using the Delaware Tax Trap OBIT technique is completely immune to the *Kurz or “powerholder control”* argument. Hence, some attorneys may prefer it, despite the advantages of formula GPOAs, for those estates that would likely be subject to capping. Pros and cons comparing the two techniques are discussed below.

Some may fear that using an LPOA to appoint to the same beneficiaries as would inherit by default might be illusory or disregarded. After all, what’s so different from appointing to trusts with PEG powers granted to children and a default that distributes to them outright? Thankfully, Treasury guidance should prevent this result.[[148]](#footnote-149)

1. **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 than if there were also a testamentary GPOA. Unless the appointment triggers the DTT, or unless income is mandated payable to the powerholder, exercising a lifetime limited power causes no taxable gift (or, at least it would probably be negligible value, as discussed elsewhere herein), 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 insurance, cash or loss property not subject to the testamentary power? Can a trustee or trust protector, if permitted, simply remove a testamentary GPOA prior to any lifetime appointment to avoid any gift argument, and subsequently add it back without ill effect?
* **Access by Powerholder’s Estate’s Creditors** – There is no asset protection issue if a 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, and potentially whether the GPOA is *exercised*, creditors of the testamentary GPOA powerholder’s estate may have access (see discussions and citations in Part III.h.).
* **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. If the beneficiary is not involved or does not consent to the removal of a GPOA, can there be a taxable gift? Arguably no, but it’s not 100% clear.
* **Easier to go beyond formula wherever/whenever inclusion may be desirable** – Because the LPOA in the document would not be limited by formula (or need not be, it may depend on the settlor’s intent), its exercise can easily cause inclusion beyond the federal and state 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 state and federal income taxes saved by beneficiaries by obtaining extra basis 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 is already close - consider that very low basis collectibles may be taxed to a beneficiary upon sale in a high tax state (31.8% federal + up to 13.3%) at a rate higher than the estate tax (40% federal).
* **Actions of the powerholder/trustee irrelevant.** As discussed herein, there is an argument that trustee’s investment policy, powerholder spending or estate devise, pursuant to the *Kurz* case or otherwise, could be invoked by the IRS to override the cap and cause more assets than desired to be subject to a formula testamentary GPOA. While I think this is a weak and ultimately losing argument, 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* may have some post-mortem control over asset protection, estate taxation/basis** – A recipient/appointee *might* be able to 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 (by contrast, it is *impossible* for recipients to affect whether a GPOA is held at death or not). To the extent permitted, this could be important to flexibly allow increased inclusion to yield federal, state and/or local income tax benefits by additional step up, or prevent over-inclusion, or improve asset protection at the expense of a step up in basis. Disclaimers can be made partial or by formula.[[149]](#footnote-150)

However, there are various complexities when disclaiming property received as a result of the execution of a *limited* power of appointment.[[150]](#footnote-151) A disclaimer is only “qualified” for gift/estate tax purposes pursuant to IRC §2518 if it is made within 9 months of the *creation* of the ***first*** power (or in the later event of nine months from a minor disclaimant turning age 21).[[151]](#footnote-152) This is in contrast to receipt after the execution or even lapse of a *general* power, which grants and starts a new nine month disclaimer window. There is an argument that a triggering of the Delaware tax trap should be treated more like the exercise of a general power for subsequent disclaimer purposes, but since the regulation cited above mentions no exception, and also precludes a new time period for disclaimers of interests created through exercise of limited powers in QTIPs despite estate inclusion, this argument is unlikely to prevail (an exercised limited power triggering the trap is NOT within the definition of a general power, it merely has the same estate/gift tax effect).

Does that mean there is no chance to disclaim a PEG power absent quick successive deaths or a minor power holder? Not necessarily – it just means the disclaimer is not “qualified” and could constitute a taxable gift, though depending on the scheme of who takes in default and under what terms, the gift may be incomplete or even to oneself. Because so few people will ever fully use their lifetime gift tax exclusion, practitioners should explore when *non-qualified* disclaimers may make sense, when state law will still allow a disclaimer and what its effect will be. Most state laws are much more lenient on the time window for acceptable disclaimers than §2518 (there may be no time limit).

A non-“tax qualified” disclaimer may still “relate back”, and retroactively eliminate a property interest such as a PEG power and it may still have beneficial asset protection effects, despite being a taxable gift for federal tax purposes, provided it comes under state disclaimer law rather than be deemed a common law release. A *non-qualified* disclaimer may also remove the PEG power retroactively to affect the taxation of the exercise of the power that appointed to the trust that contains it (e.g., negate the triggering of the Delaware Tax Trap). This is in contrast to a common law release or renunciation, which probably does NOT have the same effects for state law, nor, therefore, for avoiding the Delaware tax trap.

This can get confusing – let’s take an example and walk through the distinctions: John Doe dies and establishes an Irrevocable Trust for his wife Jane. She has the limited power to appoint appreciated assets to Margaret or to Margaret in trust, such as the Jane Doe Delaware Tax Trapping Trust fbo Margaret, which grants Margaret a PEG power (**p**resently **e**xercisable **g**eneral power of appointment, which, remember, is very similar to a *Crummey* power withdrawal power, but which may, depending on state law, be curbed for DTT purposes to only being exercisable with adverse or non-adverse parties). To the extent Jane appoints to this trust, and Margaret has a PEG power, it triggers IRC §2041(a)(3) – the Delaware Tax Trap. Unless Margaret disclaims within 9 months of ***John’s*** death (or unless she recently turned age 21), her disclaimer cannot be “qualified” under IRC §2518. But, what if Margaret makes a *non-qualified* disclaimer of the PEG power – one completely valid under state law, just not IRC §2518? For federal tax law, she has clearly made a gift (how much, to whom and whether it’s complete is another question). Under most state laws, a valid disclaimer still “relates back” to the time of creation, which is arguably *John’s death, not Jane’s*. Does disclaiming the PEG power allow Margaret to eliminate any estate inclusion in Jane’s estate due to the DTT, even though it is ***non-qualified***?

While there is no case law on point, whether the disclaimer of a PEG power is gift tax-qualified or not should make no difference for the Delaware Tax Trap – we need to examine both the trust and state law, since the regulations state that “Whether a power of appointment is in fact exercised may depend upon local law”, and in contrast to GPOAs, §2041(a)(3) is only triggered by valid exercise.[[152]](#footnote-153) As a general rule, the disclaimer of an interest received via exercise of a power of appointment, regardless of whether it is “tax-qualified” per §2518, will relate back as if the object had predeceased the powerholder (e.g., in our above example, as if Margaret predeceased her mother Jane).[[153]](#footnote-154) We might then have to examine the trust and state anti-lapse statute – would the PEG power be eliminated, or simply pass to her issue per stirpes? The easy answer to this is for Jane to simply draft the exercise/DTT trust clearly to preclude such application (“to the extent that my daughter Margaret disclaims her presently exercisable general power of appointment granted above, regardless of whether the disclaimer is qualified under federal gift tax law, provided it is valid under state law, such power shall be completely extinguished, despite any state anti-lapse statute to the contrary, as if the power had never existed”).

Let’s briefly contrast a common law release or renunciation, which is similar to a non-qualified disclaimer, but has important differences for asset protection and the Delaware tax trap. If Margaret accepts some of her power, or takes any action that under state law would prohibit a state law disclaimer, she might still always release or renounce her power. The effect is nearly identical *prospectively*, but the important difference between these two legal concepts is that *releases are not retroactive, whereas disclaimers are*; releases may be fraudulent transfers; disclaimers usually aren’t.[[154]](#footnote-155) The treasury regulation is clear that a *renunciation* by an appointee does not negate the exercise by the power holder.[[155]](#footnote-156)

Is the trust still a non-self-settled trust pursuant to state law after a PEG power is disclaimed? Probably **yes**. One or two states may allow a creditor to void a disclaimer if the disclaimant is insolvent, and there may be additional questions in bankruptcy or tax liens, but in general such disclaimers, even if not tax-qualified, can be effective planning tools to allow the subsequent trust to remain protected from creditors.

* **You can give your most trusted beneficiaries a de facto veto power, allowing more family control and more post-mortem flexibility than a GPOA**. 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 that estate inclusion via GPOA 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 the “non-adverse party” - they would have absolutely no fiduciary duty whatsoever to my daughters (and they, in turn, no recourse). But §2041(a)(3) does not rely on a definition of a general power of appointment – it pertains to the *exercise* of a *limited* power. If my daughters determine that for various reasons they don’t want to allow my wife’s appointment, or they would like to limit the appointment to certain assets, they can have a veto power over an LPOA, and the adverse consent requirement would not impair inclusion.

This even allows my daughter to pick and choose 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), giving additional flexibility and back up protection. For example, if my daughter and her husband had tax issues but they did not tell her mother (not uncommon in families) 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 discretionary trust without one. While a powerholder might be able to make a non-qualified disclaimer of PEG powers, a few states (***and IRS liens***), do not follow the relation back doctrine as to creditor protection, so required consent may be superior.[[156]](#footnote-157)

* **An LPOA/DTT can be used by a QTIP as well.** 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.d., if a spouse has 50% of an LLC worth $1 million and 50% owned in QTIP, the beneficiaries will get “discounted” adjustments to basis, shaving off hundreds of thousands of dollars of valuable basis – but inclusion under §2041 should lead to aggregation, *overriding* the QTIP’s segregation of assets from the rest of the estate for valuation purposes. **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 (or trust!) does not have a savings clause or construction that prevents triggering §2041(a)(3)? 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? (Very little, unless you consider the gradual escape via 5/5 lapse protection of §2514(e)). While this technique appears to work (the regulations imply so as well), there is **no** **reported case** confirming this. The only reported case on this issue found that §2041(a)(3) was **not** triggered. As discussed above, the ability to simply incorporate other states’ more favorable laws to allow more protective Delaware Tax Trapping trusts without reliance on PEG powers is also uncertain.
* **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 anadditional exercising document (usually by will), potentially a probate filing if by will (though it does not mean a full probate need be opened or that appointive assets are probate assets).[[157]](#footnote-158) Plus, invoking the DTT usually means a new separate “DTT-trapping” trust to appoint to (even if it’s only one page, or referring to another subtrust with a few sentences added).
* **Better ongoing asset protection for beneficiaries –** although the GPOA might be more prone to access by a decedent powerholder’s estate (discussed above), it is **much** more likely that one of the *children* has creditor issues than a bypass trust *spouse*/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, or subject the assets to a spousal elective share.[[158]](#footnote-159) Query how a PEG power over only the remainder interest would be viewed. This assumes a PEG power must be used and one cannot use DE/AZ law to trigger the DTT without granting a PEG power.
* **No waste of GST exclusion, assets can be excluded from *beneficiaries’* estates –** when a child or other beneficiaryinherits 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 –** When a beneficiary receives trust assets with a typical PEG Power, there is a forced grantor trust (beneficiary-deemed owner) 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, he/she can avail themselves of opportunities to avoid state income tax, shift income and obtain more favorable above the line charitable tax deduction opportunities (beneficiary-deemed owner v. non-grantor trust status is discussed in Part VII) – in short, using a typical GPOA gives more flexibility to have non-grantor or beneficiary-deemed grantor trust status in the appointive trust, rather than be forced into the latter.
* **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 may in some cases be an assignment of income. By contrast, if a beneficiary receives assets in trust without a PEG power, lifetime LPOAs and spray provisions may be used for better income tax planning with little or no gift tax burden.
* **No potential issue re triggering DTT if powerholder moves state –** If a surviving spouse or other beneficiary moves to another state or the trust changes situs/choice of law, will this affect the powerholder’s ability to trigger the DTT? Perhaps not, but it raises another potential tricky issue that formula GPOAs do not have – since those trigger estate taxation largely regardless of state law quirks.
* **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 clearly be considered the new grantor/settlor for state law as well as tax law, but if the spouse merely executed an LPOA, this would “relate back” and therefore under most state laws the original settlor would remain and 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 largely 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 may well tip the scales towards using a limited power triggering §2041(a)(3) over a formula GPOA.

State law has inadvertently become extremely elitist in this regard, with RAP savings statutes that hurt 99.8% 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. Until very recently, Delaware did not allow much more leeway either, because it barred the triggering if the trust was GST exempt (zero inclusion ratio), the very situation that 99.8% of the population will now want to use it for! However, Delaware just recently amended their statute to allow an opt-in as this white paper has advocated.[[159]](#footnote-160) State bar committees/legislatures should consider amending their RAP statutes to allow a specific reference in the instrument to “open the trap”, with an affirmative and specifically referenced “opt-in”, similar to Arizona and Delaware.[[160]](#footnote-161) Texas, Florida and Colorado bar committees have begun to consider proposed legislation for their bar/legislature to consider.[[161]](#footnote-162) More will certainly follow, especially if any favorable rulings emerge. In the Appendix is a proposed variant of Delaware’s law, modified for use in Ohio.[[162]](#footnote-163)

A more interesting question is whether we can simply incorporate one of these state’s laws into our trust for this purpose, without the need to hire a trustee in that state or have other nexus. As a general rule, common law and the Uniform Trust Code allow a settlor to choose which state law applies (or, potentially for a trustee, trust protector or court to change it):

“SECTION 107. GOVERNING LAW. The meaning and effect of the terms of a trust are determined by: (1) **the law of the jurisdiction designated in the terms unless the designation of that jurisdiction’s law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue**; or (2) in the absence of a controlling designation in the terms of the trust, the law of the jurisdiction having the most significant relationship to the matter at issue.”[[163]](#footnote-164)

Scenario: your client is on their deathbed. They are a beneficiary of a trust with highly appreciated assets in it, they have a limited testamentary power of appointment and plenty of spare applicable exclusion amount such that triggering inclusion of the appreciated trust assets in their estate would have no detrimental federal or state tax effect. The trust allows a change of situs/law or state law would otherwise allow a non-judicial settlement agreement to effect the same. Can you simply change the applicable law to Delaware or Arizona and have your client opt in to the Delaware Tax Trap by appointing to a trust that triggers the Delaware tax trap with a mere *limited* power of appointment in the appointive trust, without the need for the brute force and negative consequences of adding a PEG power?[[164]](#footnote-165) Would DE or AZ law, which permits the holder of the limited power to start a new rule against perpetuities period without referencing the original trust date, be “contrary to a strong public policy” of your state?

**Probably not**. This is a far cry from spousal elective shares, charging orders and validity of self-settled trusts, where states (and creditors!) have extremely strong interests against application of other states’ debtor-friendly or unprotective laws to assets and residents in their jurisdiction.[[165]](#footnote-166) The one exception might be states that have a state constitutional prohibition on perpetuities of some sort.[[166]](#footnote-167) However, in the majority of states, there should be no issue. The general rule is that the rule against perpetuities is simply not a “strong public policy” that would warrant an exception to the general rule stated in Section 107 of the UTC quoted above.[[167]](#footnote-168)

However, there is probably not much to lose should you simply draft the appointment in the alternative: “It is my intention that my appointment to the XYZ Delaware Tax Trapping Trust, coupled with this trust’s choice of law, trigger §2041(a)(3). Should my trust’s choice of law in this regard be void, such appointment shall be ineffective, and I hereby appoint in trust under identical terms to the XYZ Delaware Tax Trapping Trust with the following additional paragraph…[insert PEG power]”.**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 disclaimers’ impact on income tax planning – when disclaimers can paradoxically add to basis, sometimes even better than community property states, how “OBIT” clauses can be narrowly tailored to permit better ongoing income tax results and basis increases at the surviving spouse’s death, and how “OBIT” clauses often enable the next generation more tax flexibility as well.

1. **Using Qualified Disclaimers to Maximize Basis at First Death[[168]](#footnote-169)**

We don’t normally think of qualified disclaimers in the context of basis planning at the first death. Assets are either in the estate, or they’re not. But surprisingly, married couples have a unique and often overlooked opportunity to use qualified disclaimers to increase their basis in some very common situations.

Let’s explore the special disclaimer rules for jointly held bank, brokerage and investment accounts through a hypothetical upper-middle class husband and wife, John and Mary, both U.S. citizens. They have each funded a brokerage account worth $2 million and have placed each other on the account as joint tenant with right of survivorship for convenience of access and probate avoidance. No portion is community property. John’s account consists of Fund X with a value of $1.2 million, basis of $800,000, and Fund Y, with a value of $800,000, basis of $1 million (this is not a model portfolio, only for illustration!). Mary’s account consists of Fund Q with a value of $1.6 million, a basis of $1 million, and Fund Z, with a value of $400,000, basis $500,000. John dies. See columns 1 and 2 in chart below.

Under a typical scenario, John’s estate includes one-half of the value of both accounts ($4 million), or $2 million, and the basis of all of the four funds are stepped down or up 50 percent accordingly (Fund X basis increased by $200,000 to $1 million, Fund Y is decreased by $100,000 to $900,000, Fund Q’s basis is increased by $300,000 to $1.3 million, and Fund Z’s basis is decreased by $50,000 to $450,000).[[169]](#footnote-170) This amounts to a total basis increase to Mary of $350,000, with the total basis for the $4 million of assets now $3.65 million. Should Mary die first, the result to John would be exactly the same. See column 3 in chart below.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **John and Jane's funded** | **Pre-Mortem** | **Date of John’s Death** | **Basis at Death (doing** | **Basis if Mary Disclaims** |  |
| **JTWROS Accts.** | **Basis** | **Value** | **nothing)** | **Fund X** |  |
| --------------------------------------------------------------------------------------------------------------- | | | | | |
| Fund Q | $1,000,000 | $1,600,000 | $1,300,000 | $1,300,000 |  |
| Fund X | $800,000 | $1,200,000 | $1,000,000 | $1,200,000 |  |
| Fund Y | $1,000,000 | $800,000 | $900,000 | $900,000 |  |
| Fund Z | $500,000 | $400,000 | $450,000 | $450,000 |  |
| **Total** | $3,300,000 | $4,000,000 | **$3,650,000** | ***$3,850,000*** |  |

Now let’s contrast if Mary makes a **qualified disclaimer** **of Fund X**. Despite being a joint account, she is permitted to disclaim up to the entire account, because she made no contributions to it.[[170]](#footnote-171) She cannot disclaim any of Funds Q and Z to which she made all the contributions.[[171]](#footnote-172) She could disclaim Fund Y, but as we shall see, this has no income tax advantage to her. Upon disclaimer, Fund X is not merely 50 percent included in John’s gross estate pursuant to IRC §2040 for joint accounts. Because IRC § 2518 permitted Mary to disclaim 100% of Fund X, it is 100% included in John’s gross estate under IRC §2033.[[172]](#footnote-173) Remember that, as a surviving spouse, Mary would probably still receive the property outright under the will, or might receive the property in a bypass or marital trust through a pour over will clause.[[173]](#footnote-174) The basis in Fund X is now $1.2 million rather than $1 million – an increased basis of $200,000. Mary’s total basis in the four funds is $3.85 million (column 4 in chart above). Should Mary (or her trust) later sell some or all of the shares of Fund X, this creative use of qualified disclaimers may save over $60,000 in tax ($200,000 additional basis times 23.8%, plus state – it could be 8% higher if collectibles are in the account, such as a gold ETF).

Any amounts passing to Mary or to a qualifying marital trust can still qualify for the marital deduction and permit the deceased spousal unused exclusion amount to be “ported.”

Let’s reverse the order of deaths in our example. Should Mary die first, John can make a qualified disclaimer of Fund Q. 100% of Fund Q would thus be included in Mary’s gross estate. Therefore, its basis would increase by $600,000 to $1.6 million (an additional *$300,000 more basis* than had John done nothing and received the assets under survivorship). John’s total basis in the four funds would be $3.95 million, not $3.65 million. A disclaimer under this order of death saves even more (adds more basis) than if John had died first.

Note that in these two situations the basis is increased using qualified disclaimers almost as much as it would have been had the accounts been community property, and surprisingly in many cases can yield a better result. Imagine John were the breadwinner and provided *all the funding* for the above accounts and died first (not an uncommon scenario). Mary would disclaim Funds X and Q, permitting a full step up in basis to $1.2 million and $1.6 million, yet her keeping Funds Y and Z as joint accounts taxed under IRC § 2040 enables the step down in basis for those funds to be limited (new basis $900,000 and $450,000 respectively), leading to a total basis of $4.15 million – *higher than the fair market value at the date of death, and higher than what would even be possible in a community property state*.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **John contributes 100% of funds to** | **Pre-Mortem** | **Date of John’s Death** | **Basis at Death (doing** | **Basis if acct had been** | **Basis w/qualified** |
| **JTWROS Accts.** | **Basis** | **Value** | **nothing)** | **Comm. Prop.** | **disclaimer** |
| ----------------------------------------------------------------------------------------------------------------------------------------- | | | | | |
| Fund Q | $1,000,000 | $1,600,000 | $1,300,000 | $1,600,000 | $1,600,000 |
| Fund X | $800,000 | $1,200,000 | $1,000,000 | $1,200,000 | $1,200,000 |
| Fund Y | $1,000,000 | $800,000 | $900,000 | $800,000 | $900,000 |
| Fund Z | $500,000 | $400,000 | $450,000 | $400,000 | $450,000 |
| **Total** | $3,300,000 | $4,000,000 | **$3,650,000** | $4,000,000 | **$4,150,000** |

This kind of disclaimer could lead to slightly increased probate costs, of course, which will vary state to state, but this may pale in comparison to the state and federal income tax savings through achieving an increased basis.

Note that transfer on death (TOD) accounts do **not** afford nearly the same tax flexibility. If John and Mary had used TOD designations, only the $2 million of accounts owned by the decedent would be stepped up, leading to less basis under either order of death scenario. If John dies first, basis in his accounts is adjusted to $2 million, but Mary’s remains at $1.5 million. If Mary dies first, basis in her accounts is adjusted to $2 million, but John’s remains at $1.8 million. Either scenario is worse than our targeted qualified disclaimer results. Even if 100% were in John’s name, and he were to die first, using TOD designations would only result in $4 million in basis, failing to prevent the reduced step down in basis that a targeted qualified disclaimer of joint and survivorship accounts affords.

In our hypotheticals above, we assumed that the funding of the accounts was easily traceable to one spouse or the other. What if John and Mary had one joint account, and John contributed 80% of the funds, and Mary 20%? This technique may still yield greater basis increase, more so if the higher contributing spouse dies first. If John dies first, Mary can only disclaim the portion attributable to the 80% John contributed, and if Mary dies first, John can only disclaim the 20% that he did not contribute.[[174]](#footnote-175)

From a proactive planning standpoint, keeping joint accounts traceable to separate funding yields more post-mortem planning flexibility. Of course, clients don’t always keep immaculate records, and depending on the level of activity in an account, the burden of proving what level of consideration the disclaimant furnished may be difficult – but perhaps worth it.[[175]](#footnote-176)

Unfortunately, this kind of disclaimer planning cannot be done with other types of joint tenancies, such as real estate, because these forms of ownership, unlike bank, brokerage and investment accounts, usually result in a completed gift since the donor cannot unilaterally reacquire the property (although the gift may qualify for the marital deduction).[[176]](#footnote-177) One basis opportunity for such assets that practitioners should keep their eye out for, however, is whether the joint tenancy property was established prior to 1977, which may use a consideration-furnished test, or potentially whether it may be traceable to community property.[[177]](#footnote-178)

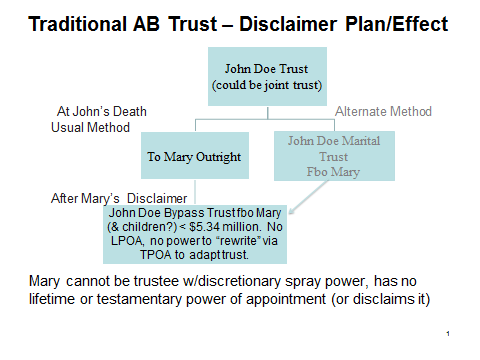
Summing up – pre-mortem planning for basis and immediate post-mortem planning for basis can yield significant income tax benefits for surviving spouses – put this on any pre and post-mortem planning checklist you may use. It may give surviving spouses an additional income tax incentive to fund their AB trusts at death with disclaimed JTWROS accounts.

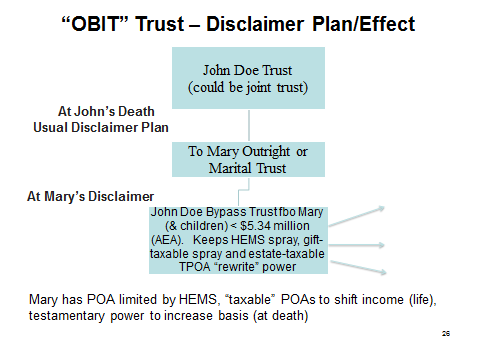
1. **What Types of Powers of Appointment Spouses Can Retain Post-Disclaimer**

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 surviving spouses are much more nuanced than that:[[178]](#footnote-179)

“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.





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 advantage to retaining a *lifetime* GPOA (and a rather severe asset protection *disadvantage*), unless perhaps it is limited to taxable income and has appropriate curbs on it, as discussed in Part VIII. Moreover, an LPOA may also be retained, but only if can only be exercised so as to trigger the Delaware tax trap (IRC §2041(a)(3) or IRC §2514(e)), or is limited by an ascertainable standard. More creatively, targeted *collateral* LPOAs held by other friendly parties, such as a sibling, could also be included and retained, without this constraint.

1. **Keeping Testamentary POAs in QTIPs Post-Disclaimer**

Surprising to many, a testamentary LPOA may be retained in a QTIP, since it would be in the surviving spouse’s estate via IRC §2044 (QTIP).[[179]](#footnote-180) The *Lassiter* holding regarding QTIP trusts surprises many practitioners – it’s rarely discussed in articles, treatises or CLEs, yet it is not a mere PLR so holding, it’s a tax court case. Be careful, however, to elect QTIP before disclaiming into the trust, rather than after, even if an additional six months may be permitted (important for Clayton QTIPs), or be clear that any ordinary LPOA is also disclaimed from any Bypass or subtrust over which QTIP is **not** elected.

So, while it is true that a disclaiming spouse must also disclaim ordinary LPOAs in a bypass trust if funded via disclaimer, a disclaiming spouse may retain narrowly crafted ones.[[180]](#footnote-181) Appropriately worded “OBIT” LPOAs and GPOAs are therefore still compatible with and complementary to disclaimer planning. Practitioners should consider creative post-mortem planning opportunities in this area – powers might be partially released rather than completely disclaimed, for example (see sample clauses). Most states should allow a partial release/nonqualified disclaimer of a testamentary LPOA unless the document forbids it.[[181]](#footnote-182)

Retention of LPOAs or formula 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 VIII 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.

**d. How OBITs often open up better post-mortem disclaimer planning at *2nd death***

Not only do OBITs enable better and more flexible estate planning at the first death, they permit more flexible estate planning at the *surviving* spouse’s death. As discussed in Part III, the general rule for qualified disclaimers is that an appointee attaining property from the exercise of a ***limited*** power of appointment, even if the assets are in the decedent’s estate as a QTIP trust, must disclaim within nine months of the date of the original creation of the limited power (i.e. the date of gift for intervivos irrevocable trusts, or the date of the settlor’s death for those funded post-mortem).[[182]](#footnote-183) By contrast, an appointee or beneficiary who is taker in default of a *general* power is afforded an additional 9 month window after the death of the holder of the testamentary general power of appointment.

Let’s contrast with a brief example. Husband establishes QTIP trust or ordinary bypass trust for wife, then children. More than 9 months pass, then spouse dies. Whether she exercises a limited testamentary power of appointment or not, it is too late for the children to disclaim under §2518. If they have a taxable estate, creditor problems, pending divorce, state tax liens, would like to shift IRD income to the next generation in a lower tax bracket or to charity or any other circumstance where a qualified disclaimer might be warranted, they are out of luck – at least, there is no chance the disclaimer will be tax-qualified – as discussed in Part III it may still qualify for some aspects under state law.

By contrast, if the trust were an OBIT trust, to the extent a formula GPOA is triggered, whether it is exercised or not, §2518 would permit the beneficiaries (whether they are appointees or takers in default) an additional nine-month window from when the surviving spouse dies, without causing any ill gift/estate/GST tax effects.

So, would you prefer a trust design that enables the next generation to do disclaimer planning at the surviving spouse’s death, or forbids it?

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

1. **Community Property Nuances – Transmutation Agreements and IRC §1014(b)(6)**

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).[[183]](#footnote-184) Some property, however, perhaps nearly all, 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 (and avoiding double step downs for community property that has decreased in value) may be accomplished through postnuptial transmutation agreements and those valid under state law are also binding on the government for federal tax purposes.[[184]](#footnote-185)

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 now community property. 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, probably divided into two $1.5 million shares rather than $2/$1 million split had they not transmuted the property. But many clients could live with this, when considering that if one dies, all $3 million gets a new adjusted basis – a substantial windfall for the widow/widower - and potentially other beneficiaries.

If a couple moves from a community property state to a non-community property state, assets acquired as community property may retain that status.[[185]](#footnote-186)

Transmuting property to community status is not without drawbacks – not only would transfers decrease testamentary control and impact divisions in a divorce, but depending on the state, there may be restrictions on gifting and/or greater exposure to creditors.[[186]](#footnote-187)

1. **AK/TN/SD Community Property Trusts - Can Residents of Non-CP States *Elect* CP?**

For married couples in separate property states, jointly owned property is usually only entitled to 50% step up (or down).[[187]](#footnote-188) 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 or South Dakota 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.[[188]](#footnote-189) This should in theory give the same result as to that property as if the couple lived in a community property state.

The code section that permits the surviving spouse’s portion to be stepped up only applies to “\*\*\*property which represents the surviving spouse’s one-half share of community property held by the decedent and the surviving spouse under the community property laws of *any* State”. Would it still be held by “the decedent and the surviving spouse” if titled in trust with an outside trustee? Yes, at least for revocable living trusts.[[189]](#footnote-190)

While there is a compelling argument that these Community Property Trusts should work equally well, to date this technique has not been tested in the courts or subject to any IRS ruling, even though Alaska’s Community Property Act has been around since 1998.[[190]](#footnote-191) The only public IRS pronouncement recognizes a potential difference for an elective regime, and excepts such a regime from its guidance.[[191]](#footnote-192) Wisconsin’s statute that defaults to community property but allows a married couple to opt out received a favorable IRS revenue ruling.[[192]](#footnote-193) There is no such ruling for Alaska’s elective regime or elective community property trusts, however.

Moreover, there is a negative Supreme Court case from 1943 that denied the income tax advantages of an earlier Oklahoma elective community property regime for income tax splitting.[[193]](#footnote-194) Conclusions vary on whether *Harmon* would today control for elective community property trusts’ effectiveness for IRC §1014(b)(6), but it’s close enough to be uncertain.[[194]](#footnote-195) In their internal guidance, the IRS seems to take the position that *Harmon* would apply to the AK/TN/SD elective community property regimes.[[195]](#footnote-196)

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.[[196]](#footnote-197) Using an AK/TN/SD trustee to hold legal title and provide various trustee services (even if limited to investment or custodial services), should strengthen the argument that it is appropriate to apply that state’s law. That said, most proponents of domestic asset protection trusts did not anticipate the *Huber* decision either, which held that the state of Washington’s public policy against self-settled DAPTs trumped a choice of Alaska law.[[197]](#footnote-198)

Many couples may not be interested in a solution that requires Alaska or Tennessee or South Dakota trustee services with attendant fees and complexity, and the use of additional counsel to execute or amend the trust. Furthermore, this would not appeal to a spouse who has much more separate property than the other, because of the obvious divorce ramifications, which should be especially concerning if a practitioner is attempting to represent both spouses. There may be significant non-tax drawbacks to the arrangement, aside from the uncertainty of the tax result in light of the *Harmon* decision.

Additionally, there is at least one state in the union that has a prohibition on post-nuptial agreements (ergo, a “strong public policy” against them) – Ohio.[[198]](#footnote-199) Ohio’s statute would probably prohibit its residents from using this technique, because such transfers would “alter their legal relations” and reflect a strong public policy of the state.[[199]](#footnote-200)

Also, certain types of income and liabilities are designated as being the sole property of a spouse under federal law, even though under state law they would otherwise be community property. When this occurs, federal law preempts state law. Thus, IRA withdrawals, self-employment taxes, earned income credits, US savings bonds, railroad retirement benefits, and social security benefits are all deemed to be separate property. For adjustments to basis at death purposes, the main exception to be aware of is US Savings Bonds.[[200]](#footnote-201)

1. **The overlooked fractional interest dilemma of community property**

Discussion with attorneys about community property often ends with the conclusion that for income tax purposes, community property is clearly superior for married couples. But is it *always*? Let’s explore a few examples that may be reminiscent of the *Nowell*, *Lopes* and *Mellinger* cases discussed in Part II.d. above:

* John owns 100% real estate as separate property. He dies. Basis is full FMV as of date of death.
* John owns same as community property. He dies. Basis is *discounted* as if two 50% TIC interests.
* John owns 100% LLC, separate property. He dies. Basis is undiscounted FMV as of date of death.
* John owns same LLC, but as community property. He dies. 50% share valued w/*discount*- perhaps 15-30%?
* Same as above, but John only owns 80% of LLC and dies. His 40% is *discounted* even further- perhaps 20-45%?

The rule that most practitioners think of whereby you simply take the full value of a property and divide by two for estate tax (and therefore basis) purposes requires a *right of survivorship*:

**(b) Certain joint interests of husband and wife**

(1) Interests of spouse excluded from gross estate

Notwithstanding subsection (a), in the case of any qualified joint interest, the value included in the gross estate with respect to such interest by reason of this section is one-half of the value of such qualified joint interest.

(2) Qualified joint interest defined. For purposes of paragraph (1), the term “qualified joint interest” means any interest in property held by the decedent and the decedent’s spouse as—

(A) tenants by the entirety, or

(B) joint tenants with right of survivorship, but only if the decedent and the spouse of the decedent are the only joint tenants.[[201]](#footnote-202)

This discounting of community property surprises people (it is contrary to guidance in IRS Publication 555 on page 8, but that publication is not citable authority). However, there is clear controlling authority in the two main circuits that deal the most with community property, and in the tax court, and the above examples are simply drawn from those cases:

In *Propstra*, a decedent’s one-half share of naked real estate held as Arizona community property was held to be required to be valued at a 15% discount.[[202]](#footnote-203)

In *Lee*, a decedent’s share of 80% of a closely held corporation held as community property was held to be required to be valued as a non-controlling 40% minority interest, and her share of 100% owned as community property was required to be valued as a 50% share, and discounted accordingly.[[203]](#footnote-204)

In *Bright*, a 55% share owned as Texas community property was required to be valued for estate tax/basis purposes as two 27 ½% interests.[[204]](#footnote-205)

These cases are all discussed in Rev. Rul. 93-12, albeit in the context of gift tax valuation rather than estate tax, but the central lesson is that the advantage of community property step ups is severely muted, and can easily lead to double step ***downs***in basis, when dealing in real estate or closely held entities, if not careful. Imagine your client invests $1 million in a 90% share of an LLC held as community property, only to find out the basis is REDUCED by 30-40% when her spouse dies shortly thereafter. This may include reductions in inside basis as well as outside basis.[[205]](#footnote-206)

Most of the community property states now allow community property *with right of survivorship*.[[206]](#footnote-207) The IRS will follow state law in this regard.[[207]](#footnote-208) However, as a general rule this form is disfavored and may require express specific written agreements to be effective, not just an abbreviation on a bank or brokerage account agreement.[[208]](#footnote-209) In some states, the two forms may be mutually exclusive.

Most articles on community property trusts ignore this feature of discounting that would apply to many appreciated assets that would be common candidates for transfer, such as real estate, art or closely held business interests. That does not mean they should never be used, just that this should be factored into planning and compared to other solutions discussed herein. One solution to the above issue would be to mimic a joint with right of survivorship account within the trust (i.e., if the trust pays outright or grants the surviving spouse the right to unilaterally withdraw the assets).

**The Devastating Effect of Unwanted Discounts on 50% Interests *Without* Survivorship**

**Case TIC, CP Share Discount**

[***Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982)**](https://openjurist.org/680/f2d/1248/propstra-v-united-states)**50% 15.0%**

[***Estate of George W. Youle v. Comm’r*, T.C. Memo 1989-138**](https://www.leagle.com/decision/1989165056lhtcm159411331) **50% 12.59%**

[***Estate of Alto B. Cervin v. Comm’r*, T.C. Memo 1994-550**](https://www.leagle.com/decision/1994118368iltcm11151938) **50% 20.0%**

[***Williams v. Commissioner*, T.C. Memo 1998-59**](https://www.leagle.com/decision/1998183375bgtcm175811775) **50% 44%**

[***Estate of Brocato v. Comm’r*, T.C. Memo 1999-424**](https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=3528) **50% 20%**

[***Estate of Eileen K. Stevens v. Comm’r*, T.C. Memo 2000-53**](https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=3589) **50% 25%**

[***Ludwick v. Commissioner*, T.C. Memo 2010-104**](https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=9061) **50% 17.2%**

**Simple rounded average of the discount in the above cases: 22.0%**

**Amount of discount had these been *JTWROS* w/spouse: 0.0%**

1. **Attaining Additional Basis at First Death – Integrating Optimal Basis Techniques**

**(Including Joint GPOA or “Joint Exemption Step Up Trusts” – aka JESTs)**

The so-called “joint GPOA” (f.k.a. poorer spouse funding technique) trust proposed by some to use in separate property states could be a more viable solution. However, it could also be a disaster, because IRC §1014(e) may require a step down, but deny a step up.[[209]](#footnote-210) 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.[[210]](#footnote-211) Copying PLR 2006-04028, H puts his $2 million into his revocable living trust, W puts her $2 million into her revocable living trust.[[211]](#footnote-212) Each trust grants the non-grantor spouse a GPOA up to their remaining applicable exclusion amount (some GPOAs in the PLRs are presently exercisable, some testamentary).[[212]](#footnote-213) 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.

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 denied. 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.

1. **Marital Deduction under §2523 for Gifts to Spouse Complete at Death**

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.[[213]](#footnote-214)

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 colorable argument and several PLRs. After all, as discussed in Parts I and II, 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.[[214]](#footnote-215)

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.[[215]](#footnote-216) If a spouse or charity owns portions of the 60% it may be deductible for gift tax.[[216]](#footnote-217) 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.”[[217]](#footnote-218)

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 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.

1. **Into the Wind of IRC §1014(e) – Tacking to Increase Basis Despite the One Year Rule**

Some of the PLRs referenced below, like PLR 2006-04028 and PLR 2004-03094 (coincidentally both of which have formula powers of appointment), 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.[[218]](#footnote-219) 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 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.[[219]](#footnote-220)

IRC §1014(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 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. The Joint Committee on Taxation’s example in its explanation argues for proration.[[220]](#footnote-221)

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.[[221]](#footnote-222)

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.

If proceeds from sale of the appreciated assets are used to pay off debt, mortgages, and other expenses, it is clear from the example in the Joint Committee Report cited above that the proceeds should still receive a step up in basis, even if this indirectly benefits the donor spouse.

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, if otherwise palatable, consider making the 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 self-settled 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 equivalent, $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 those 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 that §1014(e) applies.

Can we 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?[[222]](#footnote-223) 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.[[223]](#footnote-224) Protective elections are also specifically permitted.[[224]](#footnote-225) 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?

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, he 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 a 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. low basis depreciable asset). At a minimum, the designs in the PLRs can be improved. In my opinion, the *Upstream Optimal Basis Increase Trust*, discussed in section j. below, is far superior, because it largely avoids §2523, §1014(e) and step transaction issues.

1. **Using Intervivos QTIP Trusts to Avoid the IRC §1014(e) One-Year Rule**

If a healthy spouse makes a completed gift to an intervivos QTIP trust for a terminally ill spouse on their deathbed, can all the assets in the QTIP receive a new basis at the donee spouse’s death even if the ill spouse dies within one year? Surprisingly, the answer is probably “yes”. As discussed above, IRC §1014(e) has a one-year rule denying a step up (but permitting a step down) in basis 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)”.[[225]](#footnote-226)

However, with an intervivos QTIP, §1014(e) would not apply, for several reasons. First, unlike in standard outright gift situations, the donee spouse of an intervivos QTIP does not “acquire” the property at all. At most, it’s an income interest in the property. It’s certainly not a donee spouse’s property under any state law. An intervivos QTIP trust is not even considered the donee spouse’s property for income tax purposes under grantor trust rules. It’s considered to be owned by the settlor-spouse for income tax purposes (unless we make the trust a partially non-grantor trust, which is difficult). It’s not even possible to make an intervivos QTIP trust a beneficiary deemed owner trust as to the spouse during the settlor’s lifetime. Thus, for both state law and federal income tax law, the assets in an intervivos QTIP trust are **not** the donee’s spouse’s assets and if the donee spouse dies, the prerequisite of §1014(e)(1)(A) quoted above should not apply. While §1014(b) and §1014(b)(10) deems receipt from a QTIP trust to be acquired from a decedent “for purposes of paragraph a”, it excludes any reference to “paragraph e”. Nor does it say, for example, “for purposes of this section”. Usually such definitional or deeming rules would apply to an entire section or to several paragraphs, yet that is not the case here. There is no such regulation explaining the code section.[[226]](#footnote-227) This particular oversight and parsing of the statute may not be enough to convince readers who may retort that paragraph a sets out §1014’s general rule which should include §1014(e), but there are more reasons.

Secondly, a donor could simply gift cash or non-appreciated assets to the IV QTIP trust, then swap or have the trust purchase the lower basis assets desired to be stepped up for equivalent value. In such a case, paragraph (A) would fail to apply for a second reason – that *no* *appreciated* assets were *ever gifted* into the trust, only cash or non-appreciated assets were gifted, and any highly appreciated assets later transferred to the trust would have been acquired by exchange or purchase for full and adequate consideration.[[227]](#footnote-228) This argument is probably less compelling than the others, however.

Lastly, IRC §1014(e) has a later provision that addresses estate and trusts, but with little clarity and copious loopholes:[[228]](#footnote-229)

“(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.”

There are several reasons why this paragraph does not apply to our situation. First, it only addresses a trust over ***which the decedent was a grantor***! Uniquely, in an intervivos QTIP trust the donor-spouse is the grantor. If the donee spouse dies, the donor spouse clearly remains the grantor for income tax purposes, despite the donee spouse being deemed a transferor for estate tax purposes (and potentially for GST tax purposes, depending on whether a reverse QTIP election is made).[[229]](#footnote-230)

As if all of these reasons were not clear enough, §1014(e)(2)(B) appears to deny the basis increase only if the property is “sold” by an inheriting trust. Thus, there is no rationale for denying the basis increase for depreciation purposes. Moreover, even if the property were sold, the denial of step up in basis is only to the extent the donor spouse would be “entitled to the proceeds from such sale”. While it may be common in an estate, it will be rare that a trust beneficiary is going to be entitled to the entire proceeds from the sale of trust property. The disposition of the QTIP would often not revert back to the donor-spouse outright – more often it would pass to a trust for the donor-spouse in which he or she did not have “entitlements to the proceeds from such sale” (or at most, only a portion).

Lastly, if all the other reasons were not enough, if the QTIP trust mandates the sale of the appreciated property (even if to a related party) to pay any debts, mortgages or other expenses, it is clear from the example in the Joint Committee of Taxation’s explanation of §1014(e) that the proceeds must still receive a step up in basis to the extent of such costs.[[230]](#footnote-231) Most wealthy families have some debt, especially real estate investors, and of course, debt can easily be created via promissory notes, lines of credit and intra-family lending. In many cases, there may be enough trust/estate expenses and mortgages to soak up the entire basis.

In short, there is no clear statutory or regulatory authority under §1014 to deny the use of an intervivos QTIP trust for pre-mortem planning when a spouse may die within one year of death. In fact, that Congress spoke with such specific wording argues that more amorphous “substance over form” type arguments would be inappropriate.[[231]](#footnote-232) The IRS is welcome to argue that Congress didn’t mean what it said, but this lack of authority for their position would likely get shot down in court, similar to the *Summa Holdings* case.

Perhaps all this is why the IRS did not bother to make the argument that §1014(e) applied in a recent high value, high profile, audited case on even more egregious facts than contemplated above. In *Estate of Kite v. Commissioner*, Mrs. Kite funded a QTIP trust for her husband, who died *only* *one week later*. The assets in the trust came back to her in trust (for which a QTIP election was again made) and the tax court noted *without discussion* that “All of the underlying trust assets, including the OG&E stock transferred to Mr. Kite [by Mrs. Kite via QTIP 7 days before he died] in 1995, received a step-up in basis under sec. 1014.”[[232]](#footnote-233) Thus, while we don’t have a court case explicitly approving of this technique in the face of an IRS argument, we do have the tax court noting the incredible “in your face” result without the slightest comment and a deafening silence from the IRS who would reasonably be expected to have attacked it with vim and vigor had they thought §1014(e) could apply.[[233]](#footnote-234)

This technique is superior to funding a community property trust, or even transmuting separate to community property as a resident of a community property state. Aside from the uncertainty of community property trusts, any agreement within one year that shifts separate property interests from a donor spouse into community property could still be considered a gift for income tax purposes and therefore implicate §1041(b) and §1014(e). Moreover, community property still involves significant fractional interest discounts for 50% interests.

A typical SLAT *might* work similarly if donee spouse has a testamentary GPOA or uses an LPOA to trigger the Delaware Tax Trap to appoint back to the donor-spouse, but the trust would not be as clearly protected from §2036/2038 inclusion and creditors after spouse’s death, as discussed elsewhere herein.

1. **The “Estate Trust” Alternative**

Before turning to the *Upstream* Optimal Basis Increase Trust, let’s explain and compare a lesser known alternative to JESTs and Community Property (CP) Trusts – the Estate Trust.[[234]](#footnote-235) Unlike a CP Trust (usually) or JEST, the estate trust is accomplished by making a completed gift in trust during lifetime (similar to the Upstream OBIT Trust discussed in the next section – see comparison chart). This enables the trust to escape the potential §1014(e) one year trap as long as the donee spouse outlives the donor by one year.

In contrast to the Upstream Optimal Basis Increase Trust, however, the amount of the gift to the Estate Trust can be unlimited, due to qualification for the gift tax marital deduction.

How does this type of trust work? The Settlor transfers assets in trust for spouse, and spouse alone – but the trust does not require all net income be paid, like a QTIP or GPOA marital trust under §2523 (discussed in Part II) – payment of income and principal can be discretionary. The reason the gift still qualifies for the marital deduction is that the gift is not “terminable” – any assets remaining in trust at the spouse’s death must be payable to the spouse’s estate (not with permission of non-adverse parties, or subject to other contingencies). Thus, step one is fairly simple and easier to understand and accomplish – settlor transfers $1 million of appreciated securities, for example, to spouse in an estate trust. It is clearly included in the spouse’s estate, eligible for §1014 step up, subject to §1014(e) as discussed above.

The trickier step is how to also include the trust in the *settlor’s* estate, to enable the assets to receive a step up in basis at *either* spouse’s death, while still accomplishing a completed gift necessary for the marital deduction for the gift to the spouse. To accomplish this trick, it may be necessary to use an independent trustee. Treas. Reg. §25.2511-2(b) provides:

“As to any property . . . of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case.”[[235]](#footnote-236)

However, that same regulation later provides that a gift will not be considered incomplete if the donor merely reserves the power to change the time or manner of enjoyment of the trust property:

“A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment. Thus, the creation of a trust the income of which is to be paid annually to the donee for a period of years, the corpus being distributable to him at the end of the period, and the power reserved by the donor being limited to a right to require that, instead of the income being so payable, it should be accumulated and distributed with the corpus to the donee at the termination of the period, constitutes a completed gift.”[[236]](#footnote-237)

In the case of the Estate Trust, the donor would retain the power to alter the manner or timing of the spouse’s beneficial enjoyment of the income and principal, but would not be able to name new beneficiaries or change the interests of beneficiaries as between themselves. Thus, a gift to an Estate Trust will be a completed gift, yet be enough of a string to trigger IRC §2038/2036.[[237]](#footnote-238) This string would include the ability, for instance, to amend the trust agreement to change the manner or timing of the beneficiary-spouse’s enjoyment of the income or principal of the trust and (ii) direct the trustee to make or refrain from making proposed distributions of income or principal (which power would be exercisable by his or her agent under a power of attorney in the event of incapacity). Retaining this power will cause the trust property to be included in the grantor’s estate under §2038, yet not so much to impugn the completed gift.

The issues with Estate Trusts are that independent trustees are recommended, rather than husband/wife as usually contemplated by JEST trusts and often desired by clients. Moreover, there are much larger holes in the creditor protection and fidelity to the estate plan than JEST or OBIT trusts – there is no way to restrict or tie up the surviving spouse’s ability to completely and utterly control the estate, or encumber or jeopardize it with debt or liability. Unfortunately, you cannot simply translate the estate trust concept to an inter-vivos QTIP, because the code specifically states that a valid intervivos QTIP trust is not in the donor’s estate.[[238]](#footnote-239)

1. **“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? Testamentary GPOAs exist even if the power holder has no access to corpus during the power holder’s lifetime – indeed, the powerholder’s lifetime interest is completely irrelevant.[[239]](#footnote-240) But the reason there is decades of precedent in favor of finding GPOAs even in the most extreme and dubious conditions is that the IRS always had a monetary incentive to so argue – can such precedents simply be abandoned by the courts? For TAMs, PLRs, yes – for code, regulations and court cases, **no**. Despite a surfeit of the latter, practitioners should be skeptical in such extreme and arguably abusive cases.

Ultimately, courts will have to sort out these limits. 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, is grandma a discretionary beneficiary or does she even receive some income from the trust? Analogizing to *Cristofani*, the GPOA should be upheld. Despite all the favorable precedence, it is prudent (and probably in keeping with settlor intent), that a power holder has at least some discretionary interest; ultimately, other GPOAs may 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! Granting a GPOA to someone over revocable trust assets is a disaster – a taxable gift at death, and no step up in basis under the one-year rule. 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.

1. **The Upstream *Crummey* Optimal Basis Increase Trust[[240]](#footnote-241)**

*“[O]ne of the major purposes of the federal gift tax statute [is to protect] the estate tax and the income tax”*[[241]](#footnote-242)

The $5.45 million (and rising) estate and gift tax exclusion is more than just an estate and gift tax benefit. For 99 percent of the population, it is now more appropriately considered an income tax planning tool. Many planners used to colloquially refer to the estate tax exclusion as a “coupon” not to be squandered when explaining the benefits of bypass trusts to save estate taxes. We should equally see this amount as an income tax shifting and basis increasing “coupon” not to be wasted.

Let’s explore “upstream” planning: why spouses, parents, grandparents and/or other older relatives should be considered as beneficiaries of *Crummey* trusts, even for smaller non-taxable estates, and why these same trusts should grant these same beneficiaries optimized powers of appointment. Such planning may also get around many of the issues involved in trying to achieve an increase in basis at the death of the first spouse to die for a couple’s assets even when the assets are not community property, discussed in Part V of this paper.

Let’s start with a common planning scenario and example of the technique and then analyze the possibilities, issues and limitations:

**Example**: John and Jane are in their late-60s, married, with 3 children, 5 grandchildren and 2 parents still living in their 90s. Together they have an $8 million estate, part of which is a $1 million fully depreciated property with only $100,000 basis owned by John. John gifts $140,000 to a standard grantor *Crummey* trust (aka, a spousal lifetime access trust, or SLAT) for his wife and family. However, unlike an ordinary *Crummey* trust that only names “downstream” relatives, John also includes his mother and father in-law. Each beneficiary has *Crummey* powers. The trust purchases John’s real estate for $1 million, with a small down payment and a remaining note at the applicable federal rate (AFR) or higher.[[242]](#footnote-243) With clear revenue rulings on point, this installment sale is typically ignored for income tax purposes.[[243]](#footnote-244)

At first blush, this transaction is the exact opposite of what we have been advising in recent years: low basis assets (especially those subject to 28 percent or 25 percent federal tax rates) are often the *worst* assets to give and remove from someone’s estate in many cases. Moreover, John is “freezing” his estate and lowering the potential basis step up when he’s nowhere close to needing a freeze to save estate taxes. Is John nuts? But what if John does something quite different here: his trust grants his wife, *mother and father-in-law* a narrowly crafted testamentary power of appointment. Like over 99 percent of the population, his wife, mother and father-in-law have smaller estates than their available applicable exclusion amount.[[244]](#footnote-245)

When one of them dies, the building will be included in the decedent’s gross estate under IRC §2041 and receive a new basis stepped up to the fair market value of the property pursuant to §1014 (provided one year has passed and §1014(e) would not otherwise apply). Let’s say its value increases to $1.1 million by that time (if no capital improvements are made, the basis may reduce even further if it is depreciable). If the appointive trust continues as a grantor trust as to John or Jane, or appoints to either of them directly, *they can now depreciate the building with the new $1.1 million fair market value basis*.

The ***Leveraged*** **Upstream Optimal Basis Increase Trust** - Let’s examine the ***deductibility of the debt*** and “basis for debt” rules a bit further – some may think it sounds too good to be true. In our example above, whether the debt is deductible may be irrelevant if the power holder has at least $1.1 million of available exclusion coupon to utilize. But what if we added an extra zero - $11 million of assets, with $9.6 million of debt? With significant leverage and values above the power holder’s available applicable exclusion amount, the deductibility of the debt becomes crucial to the estate inclusion and step up in basis.

Let’s review the historical tax background and regulations in this area. The granddaddy of income tax basis cases is the U.S. Supreme Court case of *Crane v. Commissioner*.[[245]](#footnote-246) In Crane, a widow inherited property encumbered by a nonrecourse liability equal to the value of the property. The property was sold several years later. In determining the amount of gain realized on the sale by the beneficiary, the court held that the beneficiary’s basis in the property was equal to the appraised value at the time of inheritance minus subsequent depreciation, but that the amount realized included the buyer’s assumption of the non-recourse debt. Important to our analysis, the property received a basis step-up on the previous death of her husband – not just the equity, *but also the nonrecourse liabilities to which the property was subject at death*.

Let’s examine some of the tax code and regulations. IRC §2053 provides that:

“Expenses, indebtedness, and taxes

(a) General rule.For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts—

**\*\*\***

**(4)** ***for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent’s interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate***, as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.”[[246]](#footnote-247)

The regulations mostly mimic the code section, but add a sentence on nonrecourse debt:

Treas. Reg. §20.2053-7 Deduction for unpaid mortgages. “***A deduction is allowed*** from a decedent's gross estate of the *full unpaid amount of a mortgage upon*, *or of any other indebtedness in respect of, any property* of the gross estate, including interest which had accrued thereon to the date of death, ***provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate***. But if the decedent’s estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be retuned as part of the value of the gross estate.[[247]](#footnote-248)

Thus, the central question in our hypothetical becomes – when John sold the property to the irrevocable grantor trust (upstream optimal basis increase trust) for the down payment and a note, *did he retain a mortgage, indebtedness, security interest or lien on the property to the extent of the debt, or does the trust simply owe the money and there is no security interest in the property*? In the former instance, §2053 would permit the deduction upon inclusion of the property in the power holder’s estate, since the debt is tied to the property. In the latter instance, it would not. A general, non-secured debt of the trust would not enable a deduction for the power holder’s estate, unless it could be deemed a claim against the power holder’s estate, which may depend on state law, as discussed in Part III. The last sentence of Treasury Regulation §20.2053-7 quoted above tells us to report the value of the net *equity* on the Form 706 (not debt listed on Schedule K) when dealing with non-recourse debt. Does the decedent power holder (John’s mother or father in law in our hypothetical) owe on the debt as a co-signer or guarantor on the note with the trustee? This would be a “belt and suspenders” approach, but is probably undesired by the family and probably unnecessary – most readers have encountered many cases where the typical husband and wife will get a basis step up on the decedent’s share (or in community property states, the entire share) regardless of whether only one spouse signed the mortgage.

So, for non-recourse debt, should we follow *Crane*, and assume any inheritor is going to get basis, despite a lower value reported (or reportable) on a power holder’s Form 706? Prudence dictates filing the lien (which might help with “reality of sale” analysis, since ordinarily unrelated parties secure large loans). Moreover, new basis regulations give a boost and confirmation to the argument that the tax basis rules enunciated in *Crane* still give basis for non-recourse debt following property to any inheritor, regardless of §2053 or how it would be reported on a Form 706, as discussed below.

If there is not land involved, but intangibles, a UCC filing should accomplish the same result as a recorded mortgage.[[248]](#footnote-249) After all, most substantial property and gifting involve closely held, usually pass-through, entities, with LLCs becoming the dominant choice. Importantly, tax partnerships (most LPs, LLCs) have their own separate treasury regulation governing basis upon death, which is quite favorable in our hypothetical:

§ 1.742-1 Basis of transferee partner's interest.

The basis to a transferee partner of an interest in a partnership shall be determined under the general basis rules for property provided by part II (section 1011 and following), subchapter O, chapter 1 of the Code. Thus, the basis of a purchased interest will be its cost. **The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent** (see section 753 and paragraph (c)(3)(v) of § 1.706-1 and paragraph (b) of § 1.753-1) under section 691. See section 1014(c). For basis of contributing partner's interest, see section 722. The basis so determined is then subject to the adjustments provided in section 705.[[249]](#footnote-250)

So, let’s revisit our hypothetical using LLCs (not electing to be taxed as corporations), keeping the above in mind. John sets up an LLC, funds it with $140,000 cash, the LLC borrows $900,000 and purchases a $1 million building. The net equity is $140,000. He gifts 10% of LLC to spouse and 90% of LLC to an irrevocable upstream grantor trust (if the trust owns 100%, or if only he and his grantor trust were owner, there would not be a tax partnership and asset protection may be reduced as well). Let’s ignore valuation discounts for simplicity (as discussed elsewhere herein and in other presentations, agreements can often be manipulated to remove most discounts anyway). The upstream trust has an LLC interest worth approximately 90% of $140,000. The basis, of course, is much higher because of the debt - $810,000 higher. Let’s say the property increases in value 50%, $500,000, from $1 million to $1.5 million - and we’ll just ignore subsequent income/depreciation, and assume interest but not principal is paid on the loan for simplicity. The value (again, ignoring discounts applicable to a 90% share) of the 90% LLC interest in the trust is now 90% of $640,000 = $576,000. The power holder dies, bringing the trust into the power holder’s estate. The basis in the hands of whomever subsequently inherits the 90% LLC interest should be, pursuant to Treas. Reg. §1.742-1 above, $576,000 (*the fair market value of the interest on the date of death or alternate valuation date*), **plus** the *successor’s share of partnership liabilities* (90% of $900,000, or $810,000) = $1,386,000. **In other words, the successor is getting FMV basis, plus additional basis for debt.** This is true even if the power holder would only report the net $576,000 as the value of the LLC interest in the power holder’s estate tax return (if the power holder is even required to file). If $10,000 of the LLC value were attributed to back rent owed, this account receivable would be income in respect of a decedent under IRC §691 and **reduce** the basis accordingly**.**

**New Basis Rules under 1014(f) should have no impact, and *reinforce* the above rules**

The §1.742 regulation explains and solves our most common basis issues, but some may be wondering if Congress recently threw a monkey wrench into this analysis, at least where non-recourse debt is concerned, in enacting the new basis reporting rules under §6035 and §1014(f), because they appear to set a cap for basis based on the value *reported for estate tax purposes, which in some cases, as noted above, excludes nonrecourse debt*.

**(f) Basis must be consistent with estate tax return.** For purposes of this section—

**(1) In general.** The basis of any property to which subsection (a) applies ***shall not exceed***—

**(A)** in the case of property the final value of which has been determined for purposes of the tax imposed by chapter 11 on the estate of such decedent, **such value**, and

**(B)** in the case of property not described in subparagraph (A) and with respect to which a statement has been furnished under section 6035(a) identifying the value of such property, **such value**.

**(2) Exception**

Paragraph (1) shall only apply to any property whose inclusion in the decedent’s estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate.[[250]](#footnote-251)

Thankfully, the proposed regulations clarify that this new code section should not affect additions to basis for debt above the value reported on the Form 706 – **the basis for the inheritor**, and that reported under §6035 and Form 8971, ***includes the nonrecourse debt***:

Example 4. (i) At D’s death, D’s gross estate includes a residence valued at **$300,000** encumbered by **nonrecourse debt in the amount of $100,000**. Title to the residence is held jointly by D and C (D’s daughter) with rights of survivorship. D provided all the consideration for the residence and the entire value of the residence was included in D’s gross estate. The executor **reports the value of the residence as $200,000** on the return required by section 6018 filed with the IRS for D’s estate and claims no other deduction for the debt. **The statement required by section 6035 reports the value of the residence as $300,000**.[[251]](#footnote-252)

Example 1. (i) At D’s death, D owned 50% of Partnership P, which owned a rental building with a **fair market value of $10 million subject to nonrecourse debt of $2 million**. D’s sole beneficiary is C, D’s child. **P is valued at $8 million**. **D’s interest in P is reported on the return required by section 6018(a) at $4 million** [note the IRS did not apply any valuation discounts – that may or may not be accurate depending on the partnership agreement, etc]. The IRS accepts the return as filed and the time for assessing the tax under chapter 11 expires. C sells the interest for $6 million in cash shortly thereafter. (ii) Under these facts, **the final value of D’s interest is $4 million** under paragraph (c)(1)(i) of this section. Under section 742 and §1.742-1, **C’s basis in the interest in P at the time of its sale is $5 million (the final value of D’s interest ($4 million) plus 50% of the $2 million nonrecourse debt)**.[[252]](#footnote-253)

Thus, we can see that leverage inside of an LLC, which is the most common use for this planning, will not impair an increase in basis to any inheritor, even if only the net equity value is what is reported on the decedent power holder’s estate tax return. Thus, to use an extreme example, a decedent power holder with a $450,000 estate or less of their own personal assets, who controls, via testamentary GPOA, a 50% of an LLC (ignoring discounts) that owns a $100 million LLC with $90 million of debt and zero basis, will report $5 million on their estate tax return pursuant to Treas. Reg. §1.742-1 and the inheritor’s basis will be $5 million plus the $45 million, which is the inheritor’s share of the LLC’s debt, or $50 million. To quote the new proposed regulations, “The existence of recourse or non-recourse debt secured by property at the time of the decedent’s death does not affect the property’s basis, whether the gross value of the property and the outstanding debt are reported separately on the estate tax return or the net value of the property is reported. Therefore, post-death payments on such debt do not result in an adjustment to the property’s basis.”[[253]](#footnote-254)

**Crafting the power**

The testamentary power can be granted to only the first to die (*a reverse tontine*),[[254]](#footnote-255) to avoid any issues with a lapse of the remaining powers, but of course, similar powers might arise in subsequent appointive trusts, allowing a cascading increasing basis with additional disregarded purchases between the settlors and their grantor trusts.

The testamentary power could be a general power or a limited power exercised in such a way as to trigger the Delaware Tax Trap. Either one can be very narrowly crafted, as discussed in Part III. Although there are differences between these two methods of estate inclusion, either one may achieve the same result of a step up in basis. Which method to choose may depend on state creditor and asset protection trust law, the financial position of the parent and the importance of continuing asset protection, grantor trust status and/or control to the settlor, as discussed in Part III.

To ensure qualification for the annual exclusion gift under the *Crummey* case and its progeny, the attorney might consider denying application of the testamentary general power of appointment to any amount of the trust still subject to a withdrawal power (which typically lapses 30-60 days after the gift). Otherwise, there is a remote chance the IRS could argue there was no “present interest” due to the possibility of a powerholder dying before the beneficiary had an exercisable right to demand the gift. This tack is probably overly conservative – there is no case denying the annual exclusion for any similar provision, the death would probably be considered an act of independent significance, it’s not so different from the remote chance of someone stealing the money or losing the funds with a bad investment, and the IRS can’t help but lose every *Crummey* case it tries to attack. Nevertheless, in most cases this provision would not impair any benefits.

Another method of ensuring a present interest, yet enabling a testamentary power that could still step up the basis in the assets, would be use a limited testamentary power of appointment that could only appoint to a trust which keeps the existing withdrawal right intact – as discussed in Part III of this paper, because such a trust would have a presently exercisable general power of appointment (*Crummey* power), the exercise of the limited power of appointment would trigger the Delaware Tax Trap under most every state law.

If the powerholder dies within one year of the gift, a step up is denied if the same assets come back to John or Jane outright, under IRC §1014(e).[[255]](#footnote-256) If the assets pass to a trust for either of them within one year, the issue is much murkier, and it may well depend on the terms of the trust and even, surprisingly, whether the property is sold.[[256]](#footnote-257) To avoid some of those issues John’s trust may require a one-year curing period before any testamentary GPOA/LPOA is effective, the power holder may appoint the property gifted within one year to a non-donor child and bequeath other property of equal value to the donor child, the successors might simply avoid sale of property until the next death and still exploit the additional depreciation, or simply take care that any permitted appointment within one year would not include payment to them outright or to a trust for them that might be disqualified for a step up in basis. But even if *some* assets come back to the donor within one year, are they *the same assets*? Were those appreciated assets “acquired by gift” by the decedent power holder, as required by §1014(e)? Arguably **no** - if a donor puts in cash, and what comes back is real estate acquired by FMV *purchase*, *the plain language of §1014(e) is not triggered*.

But wait! Don’t “bad things” happen if someone dies with a note to a grantor trust outstanding? There has been spirited debate among practitioners about whether the death of a settlor of an irrevocable grantor trust in the midst of repayment of an installment sale note with the settlor triggers income tax on the sale at death. And there is a regulation to trigger gain to the extent the outstanding liabilities owed by the trust exceed the trust’s basis in the assets if such status changes during the grantor’s life.[[257]](#footnote-258) Thankfully, neither would be an issue here, unless John were to die first.[[258]](#footnote-259)

Why isn’t the *powerholder’s* death as negative for income tax purposes as the death of the *settlor*? Well, for one thing, the basis increases to the fair market value date of death, so the trust’s liabilities would unlikely exceed the basis, unless the value had gone down precipitously post-gift. But, more importantly, it is highly likely that the parent powerholder (or John, via lapse provisions in the trust) would structure any appointment or lapse so that *the taxpayer does not change for income tax purposes anyway*.

How does the family make this happen? Well, there is the startlingly simple solution that the parent GPOA powerholder can appoint the trust assets to John outright directly,[[259]](#footnote-260) or to Jane, his wife.[[260]](#footnote-261) Or to a revocable trust or any other trust that would qualify as a grantor trust for them due to a withdrawal power over all taxable income and/or principal, as discussed in Part VIII.

But what if John and Jane want continuing tax or asset protection benefits of an irrevocable wholly discretionary trust? If the powerholder parent dies ***and exercises*** a GPOA to a trust for John or Jane, it is clear that the powerholder is the new grantor and the trust could only continue as a grantor trust as to them if a broad IRC §678(a) power applies, which would eliminate some, but not most, of the creditor protection and estate tax benefit of the new appointed trust.[[261]](#footnote-262) Ordinary exercises of limited powers of appointment clearly have no effect on the grantor for income tax purposes.[[262]](#footnote-263)

However, if the GPOA merely lapses, or a limited power is exercised in such a way to trigger the Delaware tax trap under IRC §2041(a)(3) or inclusion as an intervivos QTIP, the issue is much murkier - would this be an *indirect* gratuitous transfer per §1.671-2(e)? The mere lapse of a GPOA does not appear to override §§ 671-677 for grantor trust purposes, not only because of its conspicuous absence of mention in paragraph (e)(5) of Treas. Reg. §1.671-2, but also under the subsequent example 9, wherein the exercise of a GPOA clearly changes the grantor, but the mere presence (and presumably, lapse) of one does not override the original settlor being grantor under IRC §§ 671-677. Lapses are not necessarily “transfers”.

LPOAs triggering the Delaware Tax Trap are equally uncertain as to whether they override the original settlor’s grantor trust status. Does “generally” in the statute imply there are exceptions? Should limited powers that are treated like general powers for tax purposes be treated more like exercised GPOAs for income tax purposes?

Thus, if the parent’s GPOA merely ***lapsed*** at their death, and the trust continued with terms that kept John as a grantor under IRC §§671-677, such as power of substitution, provisions enabling income to be distributed to grantor’s spouse, etc., but no provisions that would trigger estate tax inclusion, then we apparently have the holy grail of a step up in basis, while keeping grantor trust status and still keeping the estate and asset protection benefits of the trust.

Can the settlor also be a beneficiary at that point? Who is the settlor when a GPOA lapses? It matters greatly (unless it is a DAPT state) if the original settlor becomes a beneficiary. The answer is actually quite complex and may vary from state to state. Under the Third Restatement, a powerholder is clearly considered the settlor upon lapse.[[263]](#footnote-264) Thus, the decedent parent would be the settlor of the trust, so the original settlor could be a beneficiary without the trust being considered self-settled. However, it’s unlikely that any state really follows the Restatement on this point.[[264]](#footnote-265) Under common law, the original settlor would remain the settlor even after a lapse, but not after an exercise of a general power. Thus, in many states, in order to preserve the creditor protection of the trust and enable the original settlor to become a beneficiary of the trust that is the taker in default post-lapse, the trust may have to come under a state’s DAPT statute or remain as a trust for spouse and children alone, or, of course, the parent/powerholder could exercise the GPOA.

Not all taxpayers would prefer to keep grantor trust status, however – as discussed in Part VIII of this paper, clients may prefer to exploit a ***non-grantor trust*** to shift future income to children/grandchildren who are likely subject to lower income tax rates, get better charitable deductions that avoid Pease limitations and the 3.8% surtax and/or perhaps most importantly, avoid state income taxes.[[265]](#footnote-266) The change from a grantor trust to a non-grantor trust *while the grantor is still living* causes the grantor to be deemed for income tax purposes to have transferred the assets and liabilities to the trust. The trust becomes a separate taxable entity for income tax purposes, and the grantor is taxed on consideration received by the grantor in excess of the basis in the property transferred.[[266]](#footnote-267) This sounds bad, but in our case, the grantor would probably receive no consideration, and more importantly, the basis would have been increased anyway by the power holder’s death, which is not usually the case w/installment sales to IGTs.

But, doesn’t the IRS ignore everything having to do with a grantor and grantor trust for income tax purposes, and couldn’t this include application of Code Sec. 1014 in the above instance?[[267]](#footnote-268) Some fear that if the taxpayer does not change for income tax purposes that Section 1014 should not apply. Rev. Rul. 85-13 does generally ignore transactions between a grantor and a grantor trust, but here § 2041 and § 1014 is applying not because of any *transaction* between the grantor and his trust, but because of a *powerholder’s* property interest being subject to transfer tax. There is one somewhat encouraging PLR somewhat on point but it is maddeningly inconclusive.[[268]](#footnote-269) These two statutes, §2041 and §1014, clearly apply to *lapses* of testamentary GPOAs as well as exercises – who is taxed for income tax purposes before or after the event is irrelevant.[[269]](#footnote-270) If a change in taxpayer were necessary for Section 1014 to apply a step up in basis, as some fear, then no QTIP would ever receive a new basis at the surviving spouse’s death (nor any other non-grantor trust included in someone’s estate), since the taxpayer is typically not changing in such instances just because of estate inclusion. Few would argue for such an absurd result in light of decades of marital trusts receiving a new basis.

But there is another potential quirk in the second sentence of §1014(b)(9) that might apply: if the property is acquired before the decedent powerholder’s death, the basis is reduced by depreciation. This second sentence of paragraph (b)(9) is meant to compensate for “string” gifts of depreciable property brought back into a donor’s estate. Would that apply here, since our hypothetical settlor who is also the recipient for income tax purposes had arguably *acquired* the property (for income tax purposes, if not for state law purposes) *before* the decedent’s death? It should not. Reading the paragraph in its entirety, with the clarifying regulation, it is clear that “acquire the property” refers to receiving it from the *decedent’s* direct or indirect transfer.

Treas. Reg. § 1.1014-6(a)(1) provides that “The basis of property described in section 1014(b)(9) which is acquired ***from a decedent*** prior to his death shall be adjusted for depreciation, obsolescence, amortization, and depletion allowed the taxpayer on such property for the period prior to the decedent's death.”[[270]](#footnote-271) John, our hypothetical settlor, would not be acquiring the property *from the decedent, prior to the decedent’s death* as with a “string” gift.

That said, if one does not believe the regulation provides sufficient clarity, one solution to get around this issue altogether would be to have the taker in default be the grantor’s spouse Jane instead (or a grantor trust therefore), or the powerholder could simply exercise the GPOA. Recall that the *exercise* of a testamentary GPOA (as opposed to a lapse) comes under Code Sec. 1014(b)(4), ***not*** 1014(b)(9), which would furthermore change the taxpayer receiving the property (unless the appointment is to the original settlor outright) since the powerholder would then be deemed the grantor or any trust.[[271]](#footnote-272) Any such exercise should be careful to avoid being exactly the same as the taker in default.[[272]](#footnote-273)

Most taxpayers would prefer to keep things simple and more certain and be happy to receive the assets back outright, or in trust with a presently exercisable GPOA, or settle for a trust that grants a §678(a) power over income only. For poorer families where a power holder may be on Medicaid or otherwise close to insolvent, the use of limited powers of appointment and the Delaware Tax Trap to trigger inclusion/step up should avoid any creditor/asset protection issues should the parent powerholder’s estate be insolvent or subject to claims.[[273]](#footnote-274)

Of course, these trusts are natural pourover vehicles for GRATs at the end of the annuity term, or, similar terms could be incorporated into the GRAT itself to be applied at the end of the term (an “Upstream Optimal Basis Increase GRAT”).

What about sham or economic substance arguments? In contrast to naming strangers, it is hardly a sham to name a parent as beneficiary of a family trust. Millions of people assist their parents financially anyway, so why not make those gifts from a trust best designed to benefit the entire family? An analogy for drawing the line may be made in comparing so-called “Vulture CLATs” using sick *non-relatives* as measuring lives, which the IRS ultimately shut down, with CLTs that use relatives, even sick relatives, as measuring lives, which is explicitly approved.[[274]](#footnote-275) Like regulations that govern using life expectancies of *terminally ill* relatives, §1014(e) effectively prevents “deathbed GPOA granting”.

The IRS has repeatedly tried these kinds of arguments against FLP/LLCs, *Crummey* trusts, spousal trusts and other various more egregious fact cases without success. It’s why every estate planning attorney comfortably drafts trusts for spouses and children without fear of “prearrangement” related arguments, even though parents are often forced by intestacy law to be beneficiaries of their minor children’s estates. It’s hardly a damning factor for an elderly parent to appoint trust assets back to their adult child any more than a spouse appointing back to their spouse in a SLAT or intervivos QTIP or a child appointing to their parent as beneficiary if they predecease; rather, it’s completely natural. Even in an extreme case where the parent gifts to child and child gifts to trust for parent, the parent is not necessarily deemed the grantor.[[275]](#footnote-276)

To quote one recent tax court case:

“A trust valid under state law can be treated as a nullity for federal income tax purposes if it lacks economic reality, but this would likely happen in only an extreme case. Four factors determine whether a trust has economic substance:

(1) Did the taxpayer's relationship to the transferred property differ materially before and after the trust's creation?

(2) Did the trust have an independent trustee?

(3) Did an economic interest pass to the other trust beneficiaries?

(4) Did the taxpayer respect restrictions imposed on the trust's operation as set forth in the trust documents or by the law of the trusts?”[[276]](#footnote-277)

As long as an independent trustee is used, none of these four factors would even come close. Using a family member as trustee might be more likely to implicate the other factors listed, but it would still be a very rare and abusive case indeed for the tax court to invalidate a trust – the *Close* case cited above even concerned a taxpayer found guilty of fraud, money laundering and obstructing investigations, appearing *pro se,* and even his trust was not busted - despite dubious circumstances and individual trustees.

What about the “step transaction” doctrine: could this be applied to ignore the taxable gift and power of appointment? This judicial doctrine generally requires several transactions that are so interdependent that they can’t be viewed separately, in order to collapse the steps into one integrated transaction. A court may invoke this doctrine when: (1) each step is connected by a *binding commitment*, (2) each step is *mutually interdependent*, or (3) a series of closely related separate steps to achieve an *end result* as part of a *prearranged plan* agreed to by all the parties prior to the transaction. The first two hardly apply, but the last one could with enough bad facts, such as a deathbed transaction, just as with many FLP/LLC or trust transactions. Just as with any other *Crummey* trust, FLP/LLC gift, or spousal transaction, parties should take precautions to avoid any hint of prearrangement with any power holders.[[277]](#footnote-278) But the IRS has lost much stronger cases where transactions occur only days apart, with the same parties involved, when it was clear to everyone involved beforehand what was going to happen.[[278]](#footnote-279) In a recent high profile case, the Sixth Circuit scathingly berated the IRS for its use of the *substance over form* doctrine to override the plain language of the tax code.[[279]](#footnote-280)

By contrast, here, older power holders would not even be notified of the trust before its execution and many years would often pass before a powerholder dies. During this time there would be ongoing trust administration, asset management and distributions. Older generation power holders would usually use a different attorney for their estate plan (and thus, appointments) as well. There is a not merely a *risk* of economic change of circumstance through trust administration by the time a powerholder dies, it’s a *very* *high likelihood*. This kind of “prearrangement” is not so different from someone using a bypass or QTIP trust and the IRS trying to deny the marital deduction by claiming it was all “prearranged” to pass to the couple’s children at the spouse’s death, or having an intervivos marital trust flow back to the settlor – which is even sanctioned by regulation.[[280]](#footnote-281) Quite simply, the step transaction should not apply here. While nearly all trusts are motivated in part by tax considerations, trusts for parents and spouses, such as an *Upstream OBIT*, also have a strong independent purpose and economic non-tax effect, rather than no purpose or effect beyond tax liabilities.

Courts have been quite resistant to IRS attempts to inveigh prearrangement, implied promise or concert to invalidate a tax effect clearly permitted by law, even under much more dubious circumstances.[[281]](#footnote-282)

What about the “tax benefit rule”? Isn’t the family able to deduct depreciable property upon purchase and thereafter, then deduct it again at a higher basis after the death of the beneficiary? Sometimes if it smells too good to be true it is - but not in this case. Let’s explore how the tax benefit rule works and why it does not apply in a situation where an intervening death causes a step up in basis of depreciable assets.[[282]](#footnote-283) In *Backemeyer*, a farmer died in early 2011, having spent and legitimately expensed over $300,000 for herbicides, seed, diesel fuel, fertilizer in the year before his death, 2010. His widow inherited the farm and goods, about $235,000 of which had not been used, and she farmed the land using the assets, and deducted those amounts in 2011 and 2012. The IRS initially denied the deductions, claiming that it would be unfair to allow her “double deductions”, citing the tax benefit rule, which is defined as:

“[A]n amount must be included in gross income in the current year if, and to the extent that: (1) The amount was deducted in a year prior to the current year, (2) the deduction resulted in a tax benefit, (3) an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based, and (4) a nonrecognition provision of the Internal Revenue Code does not prevent the inclusion in gross income.”

While prongs #1 and #2 were clearly met, death was not to be deemed an event that is fundamentally inconsistent with the premises upon which the deduction was originally based and the tax court permitted the widow the $235,000 of “double deductions”:

“The reason for this is that the estate tax effectively “recaptures” section 162

deductions by way of its normal operation, obviating any need to separately apply

the tax benefit rule. When Mr. Backemeyer died, all of his assets, including the

farm inputs, became subject to the estate tax, which operates similarly to a mark-

to-market tax when the mark-to-market tax is imposed on zero-basis assets.

\*\*\***The same result obtains even if Mr. Backemeyer’s estate did not actually owe any**

**amount payable as estate tax through the operation of the unified credit, see sec.**

**2010, or the marital deduction for bequests to a surviving spouse, see sec. 2056, so**

**long as his estate was subject to the estate tax regime**.

Thus, the step up in basis is not a reversible “tax benefit” even for depreciable property, because of the intervening estate tax regime, but it can clearly be a free lunch when there is no actual estate tax, because of the unified credit and/or marital deduction (like any inheritance). With upstream “OBIT” planning, we’re utilizing the unified credit, but we can use the marital deduction for very similar planning as well, as discussed in the following section and the material on designing the Optimal Basis Increase LLC.

Advisors often ask whether this same technique can be accomplished by granting GPOAs to power holders in *revocable* trusts (or incomplete gift trusts such as DAPTs or DINGs). Generally, NO – see detailed discussion above regarding JEST trusts. Not only would this cause a taxable gift to occur on the death of the power holder from the settlor to the power holder that would obviously not qualify for the marital deduction, but it would also fail to achieve any step up in basis under §1014(e) (yet could cause a step down), because the transfer back to the donor/spouse would be simultaneous, not just within one year.

1. **Intra-Spousal Planning: Building on the Joint Exempt Step Up (JEST) Trust concept**

One of the potential issues in planning for a step up in basis for joint GPOA trusts (aka, JESTs) is the uncertainty of whether the gift tax marital deduction will apply for the first transfer of assets from the original owner/spouse to the first decedent spouse.[[283]](#footnote-284) The IRS could easily reverse their position on the marital deduction taken in several private letter rulings, since there are good arguments for and against. The *Crummey* Optimal Basis Increase Trust (OBIT) technique basically eliminates that concern altogether by substituting the marital gift tax deduction for this first gift with the annual exclusion gift tax deduction.[[284]](#footnote-285)

Let’s take the above example with John and Jane and assume instead that they have no parents or other older “objects of their natural bounty” living that they would want to name as beneficiary or grant a power of appointment. They are in a stable long-term marriage. If John structures the same transaction as above, this works well if his wife dies first, because it can clearly be included in her gross estate with a testamentary power of appointment and there is no potential issue as to whether the granting of the POA qualifies for the marital deduction under Code Sec. 2523. Unlike an *inter vivos* QTIP, we can also avoid step downs in basis and be much more flexible in planning.

Furthermore, there is much less likelihood of Code Sec. 1014(e) applying, since Jane will probably live a year after the transfer, and the trust, of course, can have springing GPOAs or alternative dispositions if Jane dies before or after one year of the initial gift to address that possibility.

But what if John dies first? If he has enough warning before death, he or his agent can swap assets, cancel the note and ideally put high basis assets in the trust. But sometimes life (and death) can surprise us. Could the family avoid that risk and trigger inclusion in his estate somehow?

Actually, triggering estate inclusion is easy through various retained powers; the more difficult task is triggering it without making the gift incomplete. This is the exact opposite of Delaware Incomplete Gift Non-Grantor Trust (DING) planning, where the goal is to deftly cause a transfer for income tax filing purposes but not gift tax purposes. It is completely opposite of how we typically planned pre-ATRA, or still plan for wealthier clients.

Generally, retaining a testamentary power of appointment or power of disposition makes the gift at least partially incomplete.[[285]](#footnote-286) Recall the recent stir caused by CCA 2012-08026, in which the IRS claimed that a mere testamentary POA retained is NOT enough by itself to make a gift wholly incomplete, it merely makes the remainder interest incomplete, and the lifetime interest may be complete.[[286]](#footnote-287)

If, however, a trustee via decanting or trust protector or court reformation were to later grant a limited formula testamentary power of appointment to John, the gift will still have been complete, but there would now be a “string” causing partial estate inclusion to the extent of the power under § 2038.[[287]](#footnote-288) If there is a cap or limit on the power (e.g., as to the appreciated real estate, but not the cash or loss assets), this limit would correspondingly reduce the assets subject to inclusion under §2038.[[288]](#footnote-289) This is similar to the recent ruling outlining that only a *portion* of a GRAT is included in a settlor’s estate under §2036 should they die during the annuity term.[[289]](#footnote-290) Furthermore, such a power could easily be removed or released later to remove the estate inclusion taint, though a formula might effectively avoid the need to.[[290]](#footnote-291)

However, such changes risk the IRS arguing that there is a prearrangement or step transaction with the trustee/trust protector (ergo, never really a complete gift or causing inclusion of the full amount under §2036), or that it will simply never be accomplished. The latter is probably the greater risk, especially if there are no bad facts indicating prearrangement or control, or better, if the trustee or trust protector acting was not even appointed at the time of funding.

Rather than relying on later changes, the settlor could simply *retain a power that causes estate inclusion over only the intended assets, yet does not cause a gift to be incomplete*. Only the power to “change the manner or time of enjoyment” would be retained.[[291]](#footnote-292) For example, the settlor could retain the power to veto early distributions of appreciated assets to beneficiaries. This would involve “changing the manner or timing of enjoyment”, enough to trigger §2038 as to those assets, yet not be so much as to “change the disposition” that would make the entire gift (or any part) incomplete pursuant to §2511.[[292]](#footnote-293)

If the trust is to be funded partially with *Crummey* gifts, and the settlor still wants to be able to cause estate inclusion, yet not cause a gift to be incomplete, care should be taken to avoid impairing the present interest. Retaining a veto power over the withdrawal right would likely negate qualification for the annual exclusion.[[293]](#footnote-294) Can we be certain that §2038 would be adequately triggered if the veto right only applied after the 30 day withdrawal period? While it probably would be, this issue could also be addressed by including the power to accelerate the timing of a beneficiary’s enjoyment, e.g. the trustee may distribute, and for 30-60 days the beneficiary may withdraw $28,000 worth of contribution to the trust. Thereby, the Settlor retains the power to force the trustee to accelerate the distribution.

Attorneys should avoid pot trusts that permit unequal distributions to beneficiaries prior to division – if the settlor can veto one beneficiary’s distribution, but not another’s, then such a power would indirectly change the *disposition* of the trust (making the gift incomplete) as well as the timing. By contrast, if separate shares/subtrusts are used, or if unequal distributions are treated as advancements, then any veto would not change the disposition scheme, only the timing (permitting the gift to be complete).

Another method of making a completed gift trust while retaining grantor access and spousal inclusion is to copy the structure in PLR 8727031.[[294]](#footnote-295) In this PLR, an 80-year old husband had established a trust that:

“provides that the trustees are to hold the principal for a trust term to last until the first to occur of 1) the expiration of 3 years after the date of the trust; or 2) the donor's death. The trustees are to pay the net income to the donor during this term. If the trust term terminates upon the expiration of 3 years after the date of the trust, the trustees shall hold the principal in further trust for the benefit of the donor's wife and then living descendants. The trust instrument also provides that if the donor dies to before the expiration of the 3 year term, he has a general power to appoint the property of the trust by will.”

Despite the husband retaining a testamentary GPOA, the IRS ruled that:

“the donor's power to recapture the transferred property is not subject to a condition within the donor's control. The donor's testamentary power to appoint the trust assets is contingent upon the donor dying before a specified date, a condition which is, for legal purposes, beyond his control. Accordingly, **it is concluded that the donor has made a completed gift**, under section 2511 of the Code and the regulations thereunder, of a remainder interest in the trust to his wife and descendants.”

If this transaction were done today it would be a completed gift of the entire corpus, not just the remainder interest, under Chapter 14, which was passed in 1990 after this PLR. This may be small beer with a $11.4 million exclusion (at least for 2019). There is nothing in the ruling that would change the result if the 3-year term were changed to 30 years. Thus, this PLR gives us a road map to making a completed gift that will surely be in the grantor’s estate if they die while retaining the income and GPOA, pursuant to IRC §2036 as well as §2038, and could equally be in the spouse’s estate, if a testamentary GPOA were also granted to her. Voila, double inclusion.

1. ***Irrevocable* OBITs: Preserving Basis of Loss Property, especially Community Property**

Let’s take a different spin and imagine that John and Jane also have a wonderful second home purchased at the height of the real estate boom – the basis is $1,000,000, but the fair market value is now *only $600,000*. If John or Jane dies and it is deemed community property, the basis of the property is stepped *down* to $600,000. The same occurs even in a separate property state if both die (or, with discounting, it could be worse if the survivor does not own 100%), or if a spouse who is 100 percent owner dies.[[295]](#footnote-296) If it is held in equal joint tenancy with right of survivorship and one dies, the basis is still reduced, but only half as much.[[296]](#footnote-297)

John can use a *Crummey* OBIT to prevent any step down in basis at John and/or Jane’s death. The transaction would in essence be similar to the above, but the GPOA or LPOA would only be active or be used to trigger estate inclusion at either of their deaths if the asset increases in value above the $1,000,000 basis. This preserves the higher $1,000,000 basis for the trust/family who later inherit, who might convert it to an asset held for investment and depreciate, sell or rent the property. One quirk to the carry over basis rules for gifts is that, if the family sells the property for anywhere between $600,000 and $1,000,000 (ignoring any later depreciation or capital improvements), there is neither gain nor loss.[[297]](#footnote-298) If the family later sells for $1.1 million, the capital gain is $100,000, not $500,000. If the family (trustee) later sells for $800,000, there is no capital gain (and no loss), not $200,000 in gain. Despite these limitations, saving $400,000 of basis can be a huge advantage for the family.

Note that in this instance, the debate about whether an ongoing installment sale triggers gain at death might still lead to some uncertainty as to whether a realization event occurs upon change to non-grantor trust status (though, presumably no gain in the above example). Thus, transfer to spouse, or completing the gifting using repeated annual exclusion gifts or gifts beyond the annual exclusion might be considered.

**Not limited to *Crummey* powers or real estate holdings**

The above examples used one parcel of real estate for simplicity, but this could easily be extended to a portfolio of stocks and bonds. The beauty of such planning is that, unlike an ordinary portfolio, the estate inclusion or exclusion via formula powers of appointment can adapt to a sustained dip in the market, as with the most recent financial crisis. We should not assume that clients and their spouses will not die during a market downturn (including the bond market, which is often overlooked by many planners as a potential source of volatility).

In the above example, we presumed that John and Jane would prefer to use annual gift tax rather than lifetime gift tax exclusion, but with $10.9 million, many taxpayers could make upstream gifts with impunity and simply forget about the *Crummey* annual exclusion gifts, or supplement them.

We used a $1 million property in the above example, but remember that, with leverage and multiple older power holders, it might easily be $45 million or $90 million.[[298]](#footnote-299) In some circumstances, existing SLATs, IGTs and other previously funded trusts may be modified to exploit this. Part VII discusses tax aspects of modifications such as adding powers of appointment to existing irrevocable trusts.

The new paradigm in financial and estate planning is to view the applicable exclusion amount as more than a mere estate tax benefit, but as an asset to be used for income tax planning as well. Congress and the courts have appropriately called the gift tax a “back stop” to the income tax. Practitioners have a duty to explore the planning possibilities for families with that back stop effectively removed for over 99 percent of the population.

**m. The “Can’t BDIT” - ensuring step up at settlor/parent’s death for BDITs**

As discussed above, OBIT power of appointment strategies can build upon the JEST concept. What about another cutting edge strategy – the beneficiary defective irrevocable (inheritor’s) trust (BDIT)? Can we build a better BDIT? There are three potential perceived drawbacks to the BDIT strategy that this paper addresses – this section will suggest a solution to the first, and Part VIII will suggest a solution to the latter two and provide citations to relevant articles. But first, let’s review what the heck a BDIT is, and its pros and cons.

A BDIT is an intervivos irrevocable trust. It is usually established by a parent for a child, but may involve other relationships. It attempts to thread a needle in three areas: income tax, estate tax and asset protection, with the most important differentiator from other third party created trusts being the income tax treatment.

For income tax purposes, its differentiating characteristic from other trusts lies in ensuring the trust is not a grantor trust as to the settlor, and that a withdrawal right causes the trust to be a “grantor” or, I prefer the term “beneficiary-deemed owner” trust as to the *beneficiary* pursuant to IRC §678(a). It does so by granting the beneficiary a *Crummey* power over the trust contribution – the lapse still deftly keeps the trust as a beneficiary deemed owner trust by keeping certain beneficiary retained rights pursuant to IRC §678(a)(2) and does not cause the trust to be self-settled by the beneficiary, by virtue of the IRC §2514 lapse protection and state law that typically references it. It can accomplish this feat without sacrificing the estate tax and asset protection benefits of third party created trusts – that is, it should neither be in the estate of the settlor nor the beneficiary, nor be subject to their creditors, absent extreme scenarios such as a fraudulent transfer upon funding, or the beneficiary dying during the limited window of a withdrawal right.

The deeming of the beneficiary as the owner for income tax purposes, yet not for estate/gift/GST and asset protection purposes, allows for installment sales and disregarded transactions between the beneficiary who is deemed the owner of the trust and the trust, just as with settlors and their revocable or other grantor trusts. By contrast, transactions between a beneficiary and a non-grantor trust, or between a beneficiary and a grantor trust as to the settlor, would typically be taxable transactions.

Of course, settlors can attempt to accomplish a similar result by making completed gifts to an irrevocable grantor trust with themselves as a beneficiary, using an offshore or domestic asset protection trust statute, such as Nevada, Ohio or Delaware, that permits self-settled trusts. However, it is unclear how much protection courts in states without such statutes (including bankruptcy courts interpreting such statutes) will grant such trusts.[[299]](#footnote-300) This creditor protection uncertainty causes estate tax exclusion uncertainty. But even aside from that concern, because the settlor would have contributed funds to such a trust and remained a beneficiary (perhaps even a potential beneficiary via trust protector), it is uncertain whether IRC §2036(a) may cause estate inclusion as a retained interest – in two PLRs, the IRS has ruled that transfers to self-settled APTs can be completed gifts, but refused to rule on §2036 inclusion, since that would be largely dependent on how the trust is administered.[[300]](#footnote-301)

It is for these reasons that taxpayers have turned to the BDIT if they have cooperative family members willing to make gifts – they can enjoy continued access to an irrevocable trust as beneficiary and continued ability to make tax-free transactions, with less asset protection and estate inclusion risk than a DAPT.

Those are the pros – what of the cons to this structure? There are three main ones: the first is the minimal amount, typically only $5,000, of the seed gift.[[301]](#footnote-302) The second is the uncertain conclusion of whether a lapse is a “partial release or other modification” necessary for continued beneficiary-deemed owner status under §678(a)(2). These are addressed in Part VIII. The last one is that, while 99.5% of taxpayers do not have taxable estates, and parents establishing BDITs are often in this category, the lack of estate inclusion in the parent completely wastes the parent’s $5.43 million (or higher) applicable exclusion amount and misses an opportunity to step up the basis on any assets contributed to the BDIT, which may include substantial assets sold to the BDIT for a note if growth exceeds the interest rate on the loan over time (which should be market rate, not AFR), not just the $5,000 seed gift funding.

So, how do we ensure that the settlor parent retains enough power to cause estate inclusion (with caps, of course), yet not so much of a power that would destroy the beneficiary deemed owner status pursuant to §678(a)? How do we turn a BDIT into a “*Can’t Beat It*”?

The answer is for the settlor to simply retain a power that causes estate inclusion over *only* the intended assets, yet does not cause grantor trust status, nor cause a gift to be incomplete, nor impair the withdrawal right necessary for §678(a) beneficiary deemed owner status and present interest. This is not exactly a simple and straightforward exercise. Counterintuitively, we’ll have to borrow some concepts from incomplete gift (ING) PLRs.

As discussed in Part V.j, we can cause targeted estate inclusion over completed gifts by retaining only the power to “change the manner or time of enjoyment” of a gift - enough to trigger §2038 as to those assets so targeted, yet not be so much as to “change the disposition” that would make the entire gift (or any part of the gift) incomplete pursuant to §2511.

It’s especially difficult for *Crummey* gifts and BDITs, because not only do we have to avoid impairing the present interest for annual exclusion purposes, but, more importantly, we do not want to interfere with the unfettered withdrawal right necessary for §678(a) beneficiary deemed owner status. If the settlor retains a veto power over the withdrawal right it would negate qualification for the annual exclusion and prevent §678(a) beneficiary deemed owner status. What if, instead, we merely include the power to accelerate the timing of a beneficiary’s enjoyment? For example, a trust might provide that normal settlement upon demand must be accomplished by the trustee within 30 days, but the settlor may cause the trustee to accelerate the distribution sooner. Or, a trust may provide that the trustee may distribute, and for 30 days the beneficiary may withdraw the contribution to the trust. The Settlor retains the power to force the trustee to *accelerate* the distribution, but in no way impair the beneficiary receiving the income upon request.

Normally, settlor retention of any distribution powers causes grantor trust status. Let’s borrow from techniques used in dozens of incomplete gift, non-grantor trust (ING) related PLRs: The settlor may retain a *non-fiduciary* lifetime limited power of appointment, limited to ascertainable standards, to enable such acceleration of benefits, or perhaps better, retain unlimited powers, but exercisable only with consent of an adverse party (thus avoiding triggering §674). The latter would more clearly enable greater inclusion/step up.

Such powers do *not* cause grantor trust status (as confirmed in all the recent DING PLRs), do not inhibit §678(a) beneficiary deemed owner status, do not prevent a completed gift from occurring, and yet its retention may still trigger a targeted inclusion under §2038 to the extent it is not otherwise capped. While §2038 does have an exception for powers only exercisable with adverse party consent, it is quite different from grantor trust exceptions – to get around §2038 inclusion requires that “the decedent's power could be exercised only with the consent of **all parties** having an interest (vested or contingent) in the transferred property”.[[302]](#footnote-303) Thus, a limited power requiring consent from “an” adverse party, but not “all parties having an interest, vested or contingent” can successfully thread the needle to cause estate tax inclusion without triggering grantor trust status.

**VI. Increased Asset Protection Opportunities Mimicking DAPTs Due to Larger Exclusion**

1. ***The “poor man’s DAPT”? – Using SLATs, “Power Trusts” and ILITs w/OBIT clauses***

In addition to the increased gift tax exclusion expanding the income tax opportunities, the increase exemptions afforded by ATRA and now the TJCA also offer up greater asset protection planning opportunities. Consider this variant of a DAPT for smaller estates: Husband sets up an irrevocable trust (a.k.a. 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/LPOA, 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.[[303]](#footnote-304) 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.[[304]](#footnote-305)

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%).[[305]](#footnote-306) 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 settlor/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 be avoided by structuring the appointive trust differently if the donee/beneficiary spouse dies 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 self-settled asset protection trust statute such as the Ohio Legacy Trust Act.[[306]](#footnote-307) This is because, if W uses a testamentary **LPOA** to appoint back to a trust for H, it would probably **not** change the settlor for asset protection purposes (the “relation back” doctrine applies).[[307]](#footnote-308)

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.[[308]](#footnote-309) 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, and marital trusts have other limitations.

*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*.

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 tax purposes, overriding H as the grantor. [[309]](#footnote-310) This overrides any provisions or conclusions that would otherwise deem H the grantor under IRC §§671-679, making it a non-grantor trust.[[310]](#footnote-311) 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.[[311]](#footnote-312) This may be another area where state law, estate tax and income tax law do not necessarily stride in lock step.

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

ILITs should not be overlooked in considering optimizing basis clauses. Often they can benefit just as much as any bypass trust. This is not to achieve a step up in basis at death on the insurance policy (though conceivably there could be some value to a step up for second to die policies) – it’s the investment appreciation ***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 protected** – over a million dollars of income tax saved depending on the brackets of the beneficiaries. And, as discussed in Section III, this can 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 is capped. Needless to say, language should coordinate with the bypass trust to be read *in pari materia*.

**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 (a.k.a. private settlement agreements) are probably not ideal, since it is unclear to what extent those can make the necessary changes.[[312]](#footnote-313) Using LPOAs may 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 – nearly twice as much depending on the years passed, inflation).

1. **Using Existing Limited Powers of Appointment to Trigger Delaware Tax Trap**

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 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 power holders and their prospective appointees would probably prefer to save income tax with a higher basis than avoid the 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 PEG power (though, as noted above, this may not be a §2518 “qualified disclaimer”). 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.

1. **Amending Irrevocable Trusts – Why they are Effective at the Power Holder’s Death**

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?[[313]](#footnote-314) Isn’t this a similar trend for IRA “see through trust” rulings?[[314]](#footnote-315)

These cases and rulings that deny the effects of state court proceedings 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, after the taxable event (i.e., does it qualify as a marital, charitable or see through trust at death).[[315]](#footnote-316) 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, and grant greater rights to the power holder, the property rights held by the power holder must change.

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.[[316]](#footnote-317) 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).[[317]](#footnote-318) 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).”[[318]](#footnote-319) 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.

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.[[319]](#footnote-320) In fact, the same distinction applies to a change in state *law*: the Service will not recognize the effectiveness, for federal transfer tax purposes, of state legislation purporting to *retroactively* change an individual's property rights or powers after the federal tax consequences have attached, but it will recognize such changes *prospectively* for federal tax purposes.[[320]](#footnote-321) Thus, there is strong precedent that private settlement agreements and 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 – no different than a complete distribution/termination of the trust.

The reverse, *removing* a GPOA, is a more difficult issue, so any reformation should strongly consider the irrevocable nature of the tax consequence. Generally, a power holder releasing a general power of appointment would trigger gift tax, and could trigger taxation of any IRD.[[321]](#footnote-322) However, there are rulings which honor this when done through court reformations, without negative gift/estate tax consequence. In one recent PLR, the IRS allowed a post-mortem court reformation to essentially remove a GPOA without adverse tax effect.[[322]](#footnote-323) An even more recent PLR ruled that the exercise of an independent trustee power that could remove or limit a GPOA would not be a taxable event triggering IRC §2514/2041.[[323]](#footnote-324) Another older IRS ruling also found that a court reformation that removed a beneficiary spouse’s testamentary GPOA would not cause a taxable gift and would be honored to avoid later estate tax inclusion.[[324]](#footnote-325)

1. **Limiting Amendments to Keep Fidelity to Settlor’s Intent**

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).[[325]](#footnote-326)

Limited amendments do much less harm to a settlor’s probable intent than a major amendment or wholesale termination, and this is reflected in the Uniform Trust Code’s slightly different standards for reformations:

“(b) A noncharitable irrevocable trust may be ***terminated*** upon consent of all of the beneficiaries if the court concludes that ***continuance of the trust is not necessary to achieve any material purpose of the trust***. A noncharitable irrevocable trust may be ***modified*** upon consent of all of the beneficiaries if the court concludes that modification ***is not inconsistent with*** a material purpose of the trust.”[[326]](#footnote-327)

Of course, if we’re dealing with an intervivos irrevocable trust where the settlor is still living, the settlor’s probable intent at the time of establishing the trust may be irrelevant, this being ignored in the primary UTC reformation provision:

1. A noncharitable irrevocable trust may be modified or terminated upon consent of the settlor and all beneficiaries, ***even if the modification or termination is inconsistent with a material purpose of the trust***.”[[327]](#footnote-328)

So, in most states, the power to amend irrevocable trusts is quite broad, but we should not assume that these amendments do not have any tax effect. The next sections will explore these potential tax effects and why the form of procurement may matter, specifically, whether a beneficiary causes the amendment, or possibly even whether a beneficiary’s non-action or acquiescence causes the amendment.

1. **Gift/Estate Tax Effect of Beneficiary Procurement or Acquiescence to Amendment**

With all the above arguments that §2041 should still apply equally to amended or reformed trusts that add a power of appointment, that is not to say that amendments may not have other effects. ***Beneficiary procurement or even acquiescence to trust amendments or terminations may have detrimental tax and asset protection effects*.** This is arguably one of the most under-discussed areas of estate and asset protection planning in light of the tsunami of non-judicial settlement agreements, amendments and court reformations increasingly being used by practitioners pursuant to the Uniform Trust Code or other law.[[328]](#footnote-329)

Let’s start with quick reminder of the broad definition of a gift for gift tax purposes (or transfer with retained interest in the estate tax context), and then explore a few cases and rulings to eke out the meaning in the context of trust amendments. Treas. Reg. §25.2511-1:

**“(c)(1)** The gift tax also applies to gifts indirectly made. Thus, ***any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax***.”

**\*\*\***

**“(g)** **(1)** *Donative intent* on the part of the transferor *is not an essential element* in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor. However, there are certain types of transfers to which the tax is not applicable. *It is applicable only to a transfer of a beneficial interest in property*. It is not applicable to a transfer of bare legal title to a trustee. A transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee (but such a transfer may constitute a gift by the creator of the trust, if until the transfer he had the power to change the beneficiaries by amending or revoking the trust). The gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth, or to ordinary business transactions, described in § [25.2512-8](https://www.law.cornell.edu/cfr/text/26/25.2512-8).

**(2)** *If a trustee has a beneficial interest in trust property*, *a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard* which is set forth in the trust instrument.

Further, Treas. Reg. §25.2511-2(a) provides that:

“The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is ***measured by the value of the property passing from the donor***, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

*If the act of transfer is involuntary, then arguably no taxable gift occurs*. However, the lines are blurred considerably in the event a putative donor could have prevented a transfer – a failure to preserve or defend one’s rights by inaction may be considered a transfer.[[329]](#footnote-330) To take an extreme example - if my son steals my assets, without my knowledge or consent, yet I fail to attempt to correct or bring suit, I have clearly made a gift – the original intent is irrelevant. In one ruling, a surviving spouse failed to object to a probate accounting where her lack of objection and acquiescence to getting less than what she was clearly entitled to was deemed to be a taxable gift to those who benefitted, despite there being no clear transfer or active action by the “donor”.[[330]](#footnote-331) In the above two deemed gift scenarios, the conclusion is easy because the donor could clearly prevent the transfer. Other cases are not so easy, especially when it’s unclear whether someone can prevent an amendment (transfer). This is equally true for decanting as well as non-judicial settlement agreements or court ordered amendments.

The *Sexton* case is instructive here. [[331]](#footnote-332) *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 that, *had the beneficiary not consented, 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). Of course, the family in *Sexton* was trying to avoid inclusion – what if, as posited herein, inclusion is the goal? Not all transfers with retained interest are evil.

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). [[332]](#footnote-333) 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”, and may be a useful citation when amending trusts to gain better ongoing income tax results as discussed in Part VIII.

Another recent PLR highlights the gift tax issue: 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.[[333]](#footnote-334) The IRS offered no guidance as to how to value such a discretionary interest, but it has consistently held that even discretionary interests have some value.[[334]](#footnote-335)

While much of this outline concerns spousal interests in trust that do not usually terminate, you will still encounter many trusts for children or grandchildren that terminate at ages 30, 40, 50 etc. It is common to hear attorneys at CLEs recommending such trusts be decanted or otherwise amended to remove the termination date so that the beneficiary’s interest can remain protected from creditors and spouses and free from estate tax. What differentiates this situation from spousal trust situations is that the beneficiary holds a vested contingent remainder interest – *the IRS will likely see any beneficiary acquiescence to extending the trust as a taxable gift*, though depending on what powers are retained, the gift may be incomplete.[[335]](#footnote-336) Even removing a HEMS (ascertainable standard) power may be gift.[[336]](#footnote-337)

The lesson: procurement or even active acquiescence to creating a GPOA or even LPOA (or removing a GPOA or vested right) that could divest a beneficiary of a property right could be a transfer and taxable gift, but the value of such gift in many cases would be minimal, since it is based on the “value conferred upon another” at the time.[[337]](#footnote-338) Outright terminations are obvious: if mom were lifetime beneficiary of a bypass trust and mom, kids, grandkids agree to terminate the trust and distribute assets to mom, the remaindermen have very likely made a taxable gift (not of the entire trust, but the value of their vested contingent remainder, and if they by virtual representation caused their children to be deprived, perhaps a smaller gift from them as well). [[338]](#footnote-339) Even if the parties couldn’t care less about gift tax, it is unclear whether §1014(e) may deny the step up (but permit the step down) in basis if mom (or other donee) dies within one year, since it is likely the assets would come back to the children (less obvious, however, is how much would be).

Adding GPOAs is much less clear, but probably does not have the same implication as a *termination*. E.g., mom is lifetime beneficiary of bypass trust, remainder to son. Mom and son agree and, pursuant to state law, procure a reformation to grant mom a testamentary GPOA. As stated in discussions of authority cited above, the IRS should have to honor this change in property rights at mom’s death if pursuant to state law. However, could the son be said to have made a gift by converting his vested remainder interest into a vested remainder interest now subject to divestment? Could this trigger §1014(e) if done within one year of mom’s death? Perhaps to a very small extent. Unlike our previous trust *termination* example, no value clearly transferred to mom – any increase in the value of her property interest is extremely minimal. This probably makes more than a few readers’ heads spin.

Here’s the nutshell – it is safer to avoid this morass of gift tax issues by avoiding beneficiary involvement in any amending actions. Do so through an independent trustee, independent holder of a collateral lifetime limited power of appointment, trust protector or possibly an interested party who could not be said to be making a gift by initiating the action.[[339]](#footnote-340) Some court ordered Uniform Trust Code and other state reformations do not require beneficiary consent to accomplish.[[340]](#footnote-341) If there is no action by the beneficiary, there is arguably no “act of making the transfer” under the gift tax regulation cited above.[[341]](#footnote-342) While there is no clear example in the statute or regulations excluding such changes from being a taxable gift if done by others, the IRS has ruled that changes effected by *state law* that removed a general power held by trustee/beneficiaries were not taxable gifts.[[342]](#footnote-343)

Finally, note that post-mortem amendments of trusts that qualified for the marital or charitable estate/gift tax deduction, or even administration contrary to trust terms, can retroactively disqualify the trust from the marital or charitable deduction that would have previously been allowed.[[343]](#footnote-344) This is logical, of course. Otherwise billionaires could leave their estates to a marital GPOA trust, and some court could remove the GPOA, and voila, tax on billions of dollars avoided. You can bet that if the statute of limitations had already passed on the decedent’s Form 706 estate tax return filing that the IRS would find some way to either reopen the estate or seek an equitable recoupment of some sort.[[344]](#footnote-345)

1. **Asset Protection Effect of Beneficiary Procurement or Acquiescence to Amendment**

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 de facto *self-settled trusts*.[[345]](#footnote-346) 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 pursuant to state law.[[346]](#footnote-347)

If the court order is retroactive *nunc pro tunc,* as a trust *construction* might be, there is a good argument that the debtor should be absolved from any fraudulent transfer claims similar to the relation back doctrine governing such rules for disclaimers in most states.[[347]](#footnote-348) However, it is wisest to avoid the argument altogether through an action initiated by a trustee (or a trust protector) other than the beneficiary, whether through court reformation or decanting. Similar to the gift tax aspects and the *Sexton* case issues mentioned above, this would ideally be done without any required consent on the beneficiary’s part.

1. **Amendments or Modifications Affecting GST Exemption**

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.[[348]](#footnote-349)

Thus, practitioners should take care not to cause any exempt trust to be modified or terminated in such a way to shift a beneficiary interest to a lower generation.

1. **Substantial amendments causing a taxable exchange under *Cottage Savings, §1001***

In a rare and extreme case, settlements and amendments of irrevocable trusts can cause an *income* taxable *exchange* pursuant to IRC §1001. This might be the most overlooked and underappreciated risk to irrevocable trust amendments, especially with fewer taxpayers concerned about the gift and estate tax. The seminal oft-cited case for this proposition is *Cottage Savings Assn v. Commr.*[[349]](#footnote-350) In that case, the taxpayer, a savings and loan, had exchanged one group of mortgages for another set of mortgages. The exchanged mortgages were substantially identical in many respects. Nevertheless, the court determined that the exchanged mortgages were of legally distinct entitlements because of the material difference in the obligors and security and the legal entitlements pertaining thereto. Therefore, the taxpayer was determined to have disposed of its interests in the exchanged mortgages and could recognize the loss, for income tax purposes.

Prior to *Cottage Savings*, in *Evans v. Commissioner*, the taxpayer gave her income interest in a trust to her husband, who agreed to pay her a fixed lifetime annuity. The tax court concluded that this was also a taxable realization event (this was prior to enactment of IRC §1042 that now generally disregards sales between spouses).[[350]](#footnote-351) In other prior rulings, tenant in common owners rearranged affairs so that parcels were distributed and it was ruled an exchange (but were eligible for IRC §1031 like kind exchange treatment).[[351]](#footnote-352)

By contrast, where a taxpayer exchanged her interest in a trust for a right to similar specified annual payments from the remainderman of the trust, the 7th Circuit held that the taxpayer did **not** “dispose” of her trust interest, since the taxpayer *was to receive the exact same annual payments* from the remainderman as she had been receiving from the trust, which the 7th Circuit found to be a distinguishing factor from *Evans*. The fact that the trust and fiduciary relationship was removed altogether was not “meaningful” – there was no “change in economic position” necessary for a sale or disposition.[[352]](#footnote-353)

The IRS applied the *Evans* and *Cottage Savings* rationale against a proposed trust settlement and modification in PLR 2002-31011.[[353]](#footnote-354) The trustee and the beneficiaries (one of whom was the taxpayer in the PLR) had agreed that the taxpayer would, in exchange for the income interest he held in the trust, receive (i) a 7% annual unitrust payment from the trust, (ii) principal from the trust in the discretion of the trustee and (iii) *a testamentary general power of appointment over the remaining trust property*. Charitable remaindermen would receive an immediate payment based on the value of their remainder interest and be thereafter removed. The IRS ruled that the transaction was in effect a sale or disposition under IRC §1001(a).[[354]](#footnote-355) It’s worth reading the IRS reasoning as to why this triggered gain to avoid the disastrous result for other settlements:

“Grandson currently is entitled to trust income, subject to a floor and a ceiling. Under the proposed order, he would become entitled to annual payments of seven percent of the fair market value of the trust property, with the trustee having some discretion to make additional payments under certain circumstances. Even assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required by the Performance Chart. He also would not be limited by the Performance Chart's maximum annual payment ceilings. Finally, payments would be determined without regard to trust income. In short, Grandson's interest in the modified trust would entail legal entitlements different from those he currently possesses. ***This conclusion is reinforced by adding to the Taxpayer's current entitlement the general power of appointment over any trust corpus***, even though this was a necessary element in a favorable GST conclusion set forth in issue #3, below.”

Unlike in *Cottage Savings,* the taxpayer in the PLR was required to disregard his basis in the interests being exchanged because of their term nature, as provided in IRC §1001(e). Accordingly, the taxpayer was required to recognize capital gain *on the entire amount received. Yikes*! If you knew only of this PLR, you may be wary of doing *any* modifications to irrevocable trusts.

Thankfully, this PLR is more a fluke than a trend, and unitrust conversions and powers to adjust were subsequently granted some safe harbor regulations under §643. Let’s differentiate this ruling from the dozens of others subsequent to it that are more taxpayer friendly which held that various modifications, divisions, mergers, amendments and reformations did NOT trigger §1001 or *Cottage Savings*.[[355]](#footnote-356)

Because I’m way too lazy to analyze dozens of these PLRs (many of which are simple divisions of trusts with no additional changes), let’s pick four recent PLRs. In PLR 2010-42004, two trusts were merged, and after the modification, a withdrawal right became exercisable only during the month of January of each year, rather than at any time during the year.[[356]](#footnote-357) Despite this change, the IRS found that “no beneficiaries are acquiring new or additional interests in surviving Trust E as a result of the merger of Trust B into Trust E. Moreover, there does not appear to be any reciprocal exchange of legal rights and entitlements involving Child 2 or any of the other beneficiaries under the trusts here. Therefore, no "exchange" has occurred under § 1001.”

There are really two key questions that emerge from PLR 2002-31011 and *Cottage Savings* when amending irrevocable trusts – 1) when do you even have a “sale or exchange” pursuant to IRC §1001 and 2) if so, when would the changes be “material” differences in legal entitlement?

Is there a “sale or exchange” in most reformations? Neither one-way transfers nor administrative changes are even exchanges. As defined in the regulations,

“(d) Exchange. Ordinarily, to constitute an exchange, the transaction must be a *reciprocal* transfer of property, as distinguished from a transfer of property for a money consideration only.”[[357]](#footnote-358)

You need to watch out for two or more parties receiving substantially different interests after the reformation/settlement. I believe that if only one party is giving up or granting rights that there is no “exchange” for IRC §1001, but the IRS has viewed this more expansively in some rulings, so don’t take my interpretation of this as gospel.

In PLR 2002-31011, there was a dispute and legal settlement by which the parties were actively exchanging substantial interests – the charities were giving up their trust expectancy for immediate payout and the grandson was getting a high unitrust and greater testamentary powers in lieu of an income payout. *Evans* involved an exchange of a trust income interest for an annuity outside of trust. With any *quid pro quo* there is arguably an exchange. But with a decanting or certain court reformations that do not even need the consent of the beneficiary,[[358]](#footnote-359) the beneficiary would not be exchanging anything, nor would the trustee – there is no quid pro quo as in the 2002 PLR and certainly nothing like the obvious exchange in *Cottage Savings*. That said, there is not the need to find a voluntary component for sales and dispositions as there would be for a taxable gift.

Treasury recognizes this for trustee severances of trusts:

**(h)** ***Severances of trusts***

**(1)** ***In general.***The severance of a trust (including without limitation a severance that meets the requirements of § 26.2642-6 or of §26.2654-1(b) of this chapter) **is not an exchange of property for other property differing materially either in kind or in extent if—**

**(i) An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust**; **and**

**(ii)** **Any non-pro rata funding** of the separate trusts resulting from the severance (including non-pro rata funding as described in§26.2642-6(d)(4) or § 26.2654-1(b)(1)(ii)(C) of this chapter), whether mandatory or in the discretion of the trustee, **is authorized by an applicable state statute or the governing instrument**.[[359]](#footnote-360)

There is no clear definition of “severance” above,[[360]](#footnote-361) but decantings and unilateral constructions/reformations/divisions of trusts initiated by the trustee seem to fit a “severance” more than a “sale or disposition” – and these would of course be done pursuant to the trust and/or state law and any good trust would permit non-pro rata funding.[[361]](#footnote-362) In most instances, typical amendments are more reasonably described as a severance and/or more squarely fit with the 7th Circuit’s conclusion in *Silverstein – if the beneficiary is keeping the same payment scheme as before, with no change in economic position, it’s hard to argue there is a sale or exchange.* By contrast, contested settlements, or reformation actions initiated or negotiated *by* *beneficiaries*, particularly if a termination is involved, may come closer to resembling a *sale*, as in PLR 2002-31011 or *Evans*.

Moreover, even if there were a deemed exchange, most changes would not be nearly as *material* as in PLR 2002-31011. Still, this PLR serves as a warning to make changes as minimal as possible, and to use a method that does not require active beneficiary procurement if possible, to avoid any “sale or exchange” argument altogether. Who knows what the IRS or tax court will find to be “material”? What should we make of the statement in PLR 2002-31011 that the adding of a general power of appointment to the trust “reinforced” the conclusion that there was an exchange? Would it have been enough by itself?

If the amendment merely granted a general testamentary power to appoint to creditors with consent of a non-adverse party would it be materially different? If the amendment merely granted a *limited* power of appointment that only permitted the appointment to the same remaindermen or to trust therefore, in order to trigger the Delaware Tax Trap as discussed in Part III, would such a minimal change in the current interest be “material”?

In PLR 9352005, the beneficiary exercised a lifetime limited power of appointment to modify trust provisions concerning the naming of trustees, and *remove his lifetime limited power of appointment* in the new trust. The IRS ruled that §1001 did ***not*** apply, that the removal of a power of appointment did not affect beneficial ownership, and moreover, naturally questioned whether it could even be a transfer in the first place:

“Taxpayer and Son will be entitled to the same benefits under the new trust as they were entitled to under the 1978 trust. Son will not possess a power of appointment over the assets in the new trust. However, the exercise of the limited power with respect to the 1978 trust and the lack of a power of appointment over the new trust in this case **will not materially affect either Taxpayer or Son's beneficial interest in the property that comprises the trust principal**. Here, the rights of Taxpayer and Son as to principal and income are exactly the same under both trusts. As in *Silverstein*, previously cited, the substance of the transaction is that the beneficial interests of the parties will not change; they will be as secure as they were before, neither will realize a realistically different value under the new trust than they had under the 1978 trust, and neither will give anything meaningful in the transaction. The transfer, ***if it is a transfer at all***, is a transfer of bare legal title to the trust assets not affecting the beneficial ownership of the property.”[[362]](#footnote-363)

In PLR 2013-20004, the IRS was quite lenient and ruled that such a trust modification that removed the requirement to pay “all net income” to the beneficiary was *not a taxable gift*, ***did not trigger gain***, nor did it affect the GST zero inclusion ratio.[[363]](#footnote-364) 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.

Similarly, more recently in PLR 2016-47001, an independent trustee of an irrevocable grantor trust went to court and reformed the trust to add a power to reimburse the grantor for income taxes paid as a result of the trust’s income. This was a drastic change – *it basically allowed the grantor to be added as a beneficiary of the trust*! Yet, the IRS ruled that even this was not a gift by the beneficiaries, nor caused any taxable sale or exchange, because the grantor remained responsible for the tax and the current beneficial interests did not change by the reformation (even though the remainder beneficiaries could suffer significant dilution of their interests through future discretionary reimbursements to the grantor).[[364]](#footnote-365)

There are no clear answers, but the weight of the PLRs and more importantly the code, regulations and *Cottage Savings* and *Silverstein* cases, do not implicate relatively minor amendments that do not substantially affect what a beneficiary is currently receiving. To analogize, there is no hint in the *Cottage Savings* case that a mere minor modification of one of the taxpayer’s loans would have triggered tax – the case concerned swapping a book of loans with completely different obligors and properties as security interests!

Most common amendments contemplated by this paper should not be “sales or exchanges” - they are not negotiated between parties nor do they involve “consideration” in the contractual sense as in *Cottage Savings* and PLR 2002-31011. Even if it were a disposition, it is certainly arguable, as the IRS found in PLR 9352005, that changes should not be *material* – especially if it’s only adding a limited rather than general power of appointment, or simply adding language to allow capital gains to be part of DNI. That said, practitioners should take care to avoid a negotiated *quid pro quo* between beneficiaries or a complete overhaul (or worse, a partial termination) of a trust as in PLR 2002-31011.

An example of a potentially dangerous reformation arising out of a common occurrence would be splitting up a trust between children of prior marriage and a surviving spouse where both receive an outright distribution or separate trust with the other parties excluded and they part ways (a.k.a. a commutation). This could easily be found to be a “sale or exchange” of interests. If so found, this does not mean that 100% of such proceeds would be taxable, just that any gains would be triggered - settlement proceeds would not be taxable income if they are merely a substitute in lieu of what would have probably been an income tax-free gift/bequest.[[365]](#footnote-366) However, if the split involves IRD such as inherited IRAs or qualified plans, or assets with substantial appreciation, this may be a substantial. Or, if there happened to be a life insurance policy transferred to a non-insured party, this may be a “transfer for value” removing the usual tax-free status of the death benefit and leading to eventual taxation of the proceeds over the basis.[[366]](#footnote-367) Worse, if only the income interest is being terminated (e.g. the spouse is paid off and trust continues for children), then the zero basis rule may come into play and the income beneficiary could be taxed on the entire amount.[[367]](#footnote-368)

1. **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 trusts with wide discretion, and a more limited level available to those trusts without wide discretion. 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 common law.

The latter is a more difficult case, but such trusts are *much more common*. Why? For four main reasons: 1) because many couples want to name their spouse or child as both beneficiary and trustee or co-trustee, there is commonly a HEMS standard to prevent there being deemed a general power of appointment that would destroy asset protection and cause estate inclusion; 2) even with an independent trustee, some might want a floor to prevent the trustee from denying the intended benefits to the beneficiary and create firmer guidelines for distribution standards; 3) for marital trusts, access to income or a forced estate remainderman has to be hard wired into the trust and unchangeable to qualify for the marital deduction; and lastly, 4) for many attorneys, even for non-marital trusts, it’s just always been done that way.

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.”[[368]](#footnote-369)

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 do you define *material*? If time permits you could 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.[[369]](#footnote-370) 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 if there is no clear virtual representation?[[370]](#footnote-371) 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, especially when there is not absolute discretion to decant. Having beneficiaries simply agree that there is absolute discretion where there is not is unlikely to be availing.

The same limitation on retroactive tax effect noted above in the discussion of *Nurseryman* and other authority applies to decanting, but the prospective tax effect should be the same. The IRS has indicated for years now an unwillingness to rule on certain tax aspects of decanting and has repeatedly stated that it is “under study” and expects to issue further guidance.[[371]](#footnote-372)

1. **Decanting limits *even when there is wide discretion***

Under either common law or most decanting statutes, when the trustee has wide discretion to distribute to a beneficiary outright, a subset of this power is to appoint to a trust therefore. However, this discretion is not unlimited, and does not necessarily extend to changing or adding beneficiaries not chosen by the original settlor or the main beneficiary of the decanting power. There are not many cases on decanting, but one recent case is illustrative of its limits.[[372]](#footnote-373) In the *Johnson* case, a trustee attempted to decant two trusts that later divorced husband and wife had established for the benefit of the two settlors’ daughter, but the new appointive trust removed the daughter’s broad testamentary power to appoint to various parties and changed the takers in default should the daughter fail to exercise her testamentary power of appointment. The court held this to be an improper exercise under New York’s decanting statute (NY EPTL § 10-6.6) because it changed/added new remainder beneficiaries:

“\*\*\* the class of successor and remainder beneficiaries of an appointed trust could be narrower than the class of successor and remainder beneficiaries of the invaded trust but could not be broader. Implicit in such expression of legislative intent is: under the 2001 amendment, a trustee would not have had the authority to decant a trust in such a way as to broaden the class of successor and remainder beneficiaries.

Here, Mr. Lowenfish did just that: the class of remainder beneficiaries of the appointed trust — both the permissible appointees and the takers in default of an effective exercise of the power of appointment — is broader than the class of remainder beneficiaries of the 1985 trust. Therefore, the July 25, 2011 decanting of the 1985 trust into the appointed trust was not in accordance with the statute in existence at that time and is invalid.

\*\*\*Under the terms of the 1997 instrument, the class of permissible appointees of the trust remainder consisted of petitioner's spouse and issue. By contrast, under the terms of the instrument of the appointed trust, the class of permissible appointees consisted of the issue of petitioner's father. Thus, except to the extent petitioner's spouse is excluded, the class of permissible appointees under the appointed instrument is broader than that under the 1997 instrument. Accordingly, for the reason stated hereinbefore, the decanting of the 1997 trust violated the version of EPTL § 10-6.6 (b) (1) in effect as of July 25, 2011.”

In the *Johnson* case, the trustee was obviously impermissibly decanting to enact the settlor-father of the beneficiary-daughter’s wishes at the potential expense of the settlor-mother’s and daughter’s family, rather than acting for the best interest of the daughter-beneficiary. Let’s glean some lessons from this case to inform the broader area of using decanting powers to add limited or general powers of appointment for income tax shifting and basis purposes. First, if the decanting merely adds a testamentary limited power of appointment that permits triggering the Delaware Tax Trap in favor of trusts for existing takers in default, this is unlikely to offend most, if not all, state decanting statutes. However, depending on the state decanting statute, adding a *general* testamentary power of appointment might, since this would be broader than the takers in default (as in the *Johnson* case above). Many states’ decanting statutes, however, clearly permit this – here is Ohio’s:

“(3) If property is distributed pursuant to the authority described in division (A) of this section, the governing instrument for the second trust may do either or both of 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, or any other person, whether or not that person is a beneficiary of the first trust or the second trust*;”[[373]](#footnote-374)

Thus, the ultimate lesson is to verify that your applicable state statute clearly permits adding a general testamentary power of appointment or lifetime limited power of appointment, and if not, change the applicable situs and law to one that does. Many decanting statutes permit usage if administration is done in that state (e.g. Ohio) – a trustee could hire an agent such as a bank/trust company to help administer in such a state.

Also note that while the IRS generally has no issue with decantings that effect mere administrative changes and will still issue PLRs in that area, it is studying the potential tax effects of decanting and “will not issue private letter rulings (PLRs) with respect to such transfers that result in a change in beneficial interests. See Sections 5.09, 5.16, and 5.17 of Rev. Proc. 2011-3, 2011-1 I.R.B. 111.”[[374]](#footnote-375)

Further, while this paper generally avoids the topic of Medicaid/special needs trusts, decanting may be an ideal solution for converting what may eventually become an available resource to a beneficiary into a third-party special needs trust that is excluded as an available resource.[[375]](#footnote-376)

1. **Why legitimate modifications are superior to “self-help” terminations/distributions**

Speaking around the country on this topic, one hears plenty of anecdotal evidence of families with individual trustees simply terminating AB trusts where there is no estate tax concern – their question being, “so what if we just terminate the trust without all your expensive *lawyering*?” Despite all the asset protection concerns, and remote concerns of grandchildren suing their parents, etc., this may not lead to the estate inclusion/step up that families believe they would achieve, since it may be void.[[376]](#footnote-377)

Let’s explore a common example of this and how a savvy IRS agent or tax court may attack it. Mom is a widow and beneficiary of a bypass trust of $2 million (probably trustee or co-trustee as well). Her other assets are well under $1 million and there are no plans to move to a state with an estate tax. Mom and her children agree to simply terminate the trust by distributing all the assets to her, despite ascertainable standards limiting her distributions to health and support needs only, and she does so – let’s examine two tax scenarios – in the first mom gets $1.6 million and the kids $400,000, in the second mom gets all $2 million.

In the former scenario, such a drastic change and quid pro quo is much more like the *Cottage Savings* and *Evans* cases, and PLR 2002-31011 discussed in section g above, and is certainly not anywhere close to being a severance pursuant to the trust instrument or state law, as exempted in the safe harbor of Treas. Reg. §1.1001-1(h). So, it’s altogether probably that the family just triggered income tax pursuant to IRC §1001, overriding the general rules of Subchapter J, which would not have usually triggered any gain upon a valid terminating distribution.[[377]](#footnote-378) This might not only involve long-term capital gains, but if part of the trust included non-Roth retirement plans payable to the trust, would a deemed “sale” trigger the inherent ordinary income on *those* accounts (and/or kill the tax status even for Roth IRAs because it is partially a taxable gift of the interest)?

In our latter scenario where mom receives **all** the funds, it is less likely to be a taxable sale or exchange, because there is no reciprocal transfer – only the children/remaindermen are giving up anything. As discussed elsewhere, due to this transfer, §1014(e) could apply to deny a step up in basis should mom die within one year of termination if it is a deemed gift.

Could the IRS claim that the title to the assets never legally passed to mom, therefore the assets traceable to the bypass trust are not in her estate, therefore not even entitled to a step up in basis? Unlike Rev. Rul. 73-142 and other authority discussed previously, this “self-help” trust termination is not pursuant to state law or the document, thus encouraging the IRS to simply ignore it for tax purposes (meaning, of course, no step up in basis). There is some authority for the IRS “avoiding” distributions for estate tax purposes when done without clear authority in the instrument.[[378]](#footnote-379) Whether the statute of limitations passed on undoing any ultra-vires transfer may make a difference. Any *post-mortem* attempt by the family to ratify the action would likely be ignored for tax purposes.[[379]](#footnote-380)

In short, there is simply a lot more tax uncertainty. Following state law formalities is much more certain to achieve the estate inclusion and step up in basis that families seek. If mom and children already consent, as noted above, this would likely involve getting consent of grandchildren (the likely contingent remaindermen), which may involve a guardian of the estate or guardian ad litem, or using a state’s virtual representation provision.[[380]](#footnote-381)**VIII. The Income Tax Efficiency Trust – *Ongoing* Trust Income Tax Planning Techniques**

As mentioned in Part I, there is 2nd major income tax issue after ATRA other than basis 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.

Tax Effect to Mary and the Doe Family, during Mary’s life

At John’s Death

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.

1. **Changes to Trust Income Taxation Wrought by ATRA and the ACA**

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.”[[381]](#footnote-382)

Qualified retirement income is excluded, as well as wages, self-employment income, active business income or gain from a sale of such a business.[[382]](#footnote-383)

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”.

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,[[383]](#footnote-384) 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 25% §1250 gain or 28% rate for collectibles).[[384]](#footnote-385) 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.[[385]](#footnote-386) 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”.[[386]](#footnote-387) It is this latter aspect of trust income taxation that is often overlooked 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.[[387]](#footnote-388) Even worse, if there are substantial undistributed dividends, the alternative minimum tax could also hit hard.[[388]](#footnote-389)

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 ($400,000/yr single, $450,000 MFJ taxable income, adjusted annually for inflation), 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 paid that same level of tax anyway.[[389]](#footnote-390) 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. [[390]](#footnote-391)

**b. IRC §678(a) and the “Beneficiary Income-Controlled Grantor Trust”[[391]](#footnote-392)**

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.[[392]](#footnote-393) 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”, and we’ll eventually divide those further into “§678(a)(1) trusts” (current power) and “678(a)(2) trusts” (lapsed/released power), a variant of which is known to many as a “beneficiary defective inheritor’s trust (BDIT)”. [[393]](#footnote-394) Let’s first walk through how IRC §678(a) works, then distinguish these variants and explore some of the possibilities and limitations of such structures, especially the overlooked ones.

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](http://www.law.cornell.edu/uscode/text/26/671) to [677](http://www.law.cornell.edu/uscode/text/26/677), inclusive, subject to grantor of a trust to treatment as the owner thereof.

In the post-mortem context, the most commonly found variant triggering this provision is a marital trust that grants the surviving spouse an unrestricted right of withdrawal of the entire principal of the trust. This would clearly trigger §678(a), and the trust would be taxed no differently than the surviving spouse’s own revocable living trust. Unfortunately, such a trust offers the same tax and asset protection benefits as a revocable trust – none!

Outside that box, most practitioners mistakenly interpret §678 without the word “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.[[394]](#footnote-395) This is a commonly accepted myth, but understandable, since there 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.[[395]](#footnote-396) ***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 any 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.[[396]](#footnote-397) 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, a traditional IRA distribution might be 100% *taxable* income, but only 10% *accounting* income, and capital gains would not usually be accounting income either.[[397]](#footnote-398) 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.[[398]](#footnote-399) But a trust could easily define the withdrawal right to includecapital 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.[[399]](#footnote-400) It is *not* optional to report under Subparts A-D of Subchapter J and/or have the trust be liable for the tax.

Treasury Regulations are crystal clear that “income” in §678(a) refers to taxable income, *not* accounting income:

“(b) Since the principle underlying subpart E (section 671 and following [26 USCS §§ 671 et seq.]), part I, subchapter J, chapter 1 of the Code, is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, **it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. Accordingly, when it is stated in the regulations under subpart E that "income" is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes**.”[[400]](#footnote-401)

This is in stark contrast to the definition of income for the rest of Subchapter J (non-grantor trusts), which defaults to a completely different definition that relies on trust accounting concepts.[[401]](#footnote-402) This is the source of significant confusion among attorneys and accountants.

Refusing to take the income is not relevant to the §678 analysis, nor is renouncing the right to prior income.[[402]](#footnote-403) Although a withdrawal power is effective for §678(a) regardless of a beneficiary’s legal 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.[[403]](#footnote-404)

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).[[404]](#footnote-405) 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, subject to the trustee’s grantor trust reporting requirements under Treas. Reg. §1.671-4.[[405]](#footnote-406) If the powerholder *actually* withdraws the 5% or $30,000 as noted above, it is a generally a non-event tax-wise that, as noted in Rev. Rul. 67-241 quoted below, is not a distribution reported under Subchapter J, Parts A-D – the important income tax event is having the power itself. This is assuming that it is either paid in cash, or if paid in kind, that the trustee has the power to make non-pro rata distributions.[[406]](#footnote-407)

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.[[407]](#footnote-408) 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 those years the "realizable" economic gain necessary to make the income taxable to him.”[[408]](#footnote-409)

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.”[[409]](#footnote-410)

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.”[[410]](#footnote-411)

Thus, with the plain language of §678(a)(1), regulations under Treas. Reg. §1.671-2 and longstanding case precedent, it’s clear that beneficiaries with withdrawal rights over trust income (including capital gains) MUST report any such income on their Form 1040, regardless of whether there is any power over corpus/principal – failure to do so may lead to substantial penalties, especially since *there is no substantial authority to argue otherwise*.

Though it is not a citable precedent as the above authority is, a recent PLR is in accord: a trust had granted a §678 solely exercisable withdrawal power over the net income, with the power lapsing on the last day of the calendar year.[[411]](#footnote-412) Income was defined to include not only dividends, interest, fees and other amounts characterized as income under § 643(b) of the Code, but *any net capital gains as well*. The IRS ruled that the net capital gains, as well as the net income that would be part of DNI, would be *taxed to the power holder*.

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*.[[412]](#footnote-413) A trust could be partially subject to §678(a). If Barbara only had an unfettered right to withdraw 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.[[413]](#footnote-414) Similarly, if Barbara had a cap, e.g., up to $100,000 – then she would only be taxable to the cap, and expenses would be prorated accordingly (regardless of whether she actually takes the $100,000). 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.[[414]](#footnote-415)

A fully “beneficiary income-controlled” or “beneficiary-defective” §678(a) grantor trust does have more than 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.[[415]](#footnote-416) The most ubiquitous and valuable benefit, §121, is discussed in its own section below.

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.[[416]](#footnote-417) 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.[[417]](#footnote-418) Though more rare, provisions for taking $50,000/$100,000 ordinary rather than capital losses for sales of small business stock are unavailable to trusts, but may be available to a beneficiary under a §678(a) structure, subject to the potential caveats on treatment of losses discussed later in this section.[[418]](#footnote-419)

In fact, there is no reason that the trust cannot provide different standards for income from these special assets (beneficiary withdrawal as opposed to traditional trustee distribution), in some cases as a separate subtrust, but you would not necessarily have to (somewhat akin to some practitioners’ preference for standalone IRA trusts).

Another unique advantage of using §678(a) over using traditional 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 income from all assets *except* the muni bonds, allowing the tax-exempt assets/income to stay trapped in trust without requiring withdrawal or deemed withdrawal (to the extent no additional distributions are made). This selective character of income division cannot be done with ordinary trust distributions, which must typically carry out non-taxable income as well as taxable income.

Many practitioners already segregate IRA/qualified plan assets into separate or even standalone trusts for various tax and administrative reasons.[[419]](#footnote-420) 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, even if it is slightly more “leaky”.[[420]](#footnote-421) This asset protection drawback and inherent “leakiness” can be significantly 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%.[[421]](#footnote-422) Not to mention the investment policy of the trust.

Unlike a *Crummey* clause, forfeiture provisions (a.k.a. “cessor 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, or as one PLR did, simply the last day of the year), similar to how 5/5 power limitations are often drafted, and cessor provisions should probably only become effective prospectively so as not to impugn the “sole power”.

There is no reason that a §678(a)(1) 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, let’s 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 only shifts taxation of any ordinary income rent, traditional IRA distribution, annuity or taxable interest to the beneficiary. This exploits a larger delta of the likely tax rate differential between a trust and beneficiary, i.e. a 43.4% or 39.6% trust tax rate down to a likely 15% or 25% taxed to the beneficiary. Or, the 678(a)(1) withdrawal right might be limited to only taxable income (i.e., exempt the income attributable to Roth IRA distributions and muni bond interest).

This withdrawal power could also be capped – e.g., all income attributable to assets other than the muni bond portfolio above $12,400, or even reference an external criteria, such as income to a point until his/her taxable income exceeds $400,000/$450,000 (as adjusted for inflation) top income tax bracket. These variations certainly *complicate administration, however, and, similar to our discussions in Part III about formula powers, the desire to squeeze every last cent of tax savings leads to diminishing returns that may not be warranted because of greater complexity.* Remember that a partial grantor trust also forces a portioning of any expenses, such as investment management/trustee, attorney fees, though directly attributable expenses (e.g. real estate taxes on the residence) may be traced and be specifically allocated to the §678(a) beneficiary’s income or the non-grantor trust portion, depending on which portion is getting the income.[[422]](#footnote-423) Any structure with withdrawal rights over only certain types of assets would have issues if the beneficiary were the sole trustee or controlling investment trustee/advisor, 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 even fully grantor trusts still have nominal reporting requirements.[[423]](#footnote-424)

As we discussed in Parts II and III, estate planning practitioners often pay short shrift to the possibility that assets decline in value (hence the common use of the term “step up”, optimistically ignoring the fact that it may also be a “step down”). This is also an important concept to remember for ongoing income tax planning. If a non-grantor trust or estate incurs an anomalous net capital ***loss,*** *this is often completely wasted, unless it is a final year of termination, at which point it can pass out to beneficiaries and be used by them to the extent of gains, or up to $3,000 of ordinary income****.[[424]](#footnote-425)*** *By contrast, a fully grantor trust, even a beneficiary-deemed owner trust, wherein the beneficiary is responsible for the gains and losses on a particular asset, may pass through any capital losses directly to the beneficiary.[[425]](#footnote-426)* However, we should explore a potential tax difference here between §678(a)(1) trusts that contain a current withdrawal power over only *income*, and a §678(a)(1) or (2) trust that contains a current or lapsed/released power over the entire *corpus*.

The prospect of a loss passing through when there is only a §678(a)(1) power over income is a strange one, and merits a bit of explanation – neither the *Mallinckrodt*, *Townsend* or *Campbell* cases cited above (nor any other) dealt with the effect of a withdrawal right pursuant to §678 over *negative* income. How do you have the right to withdrawal a *negative* amount, which may be indicated if there is a net capital loss? If there is sufficient other capital gains or DNI type income, it is logical to net them, and the powerholder’s sole unfettered access and the rationale for Subpart E still makes perfect sense (e.g., if the trust has $50,000 dividends, and $30,000 net capital loss, the powerholder can withdraw an amount equal to the net taxable income of $20,000). But what if the trust had $50,000 of dividends and a $100,000 capital *loss*? The beneficiary would have no right to withdraw anything.[[426]](#footnote-427) Must or may *the beneficiary* report the loss? Probably so, but it may depend on whether the beneficiary power holder bears the burden of the loss by the trust document accounting for this and truing the books in future years. After all, it was the beneficiary power holder who has the ultimate stake in whether the assets produce a gain or not.

That said, the law is far from clear on this point. One recent PLR cited above, PLR 2016-33021, was completely silent on the issue and merely ruled that net capital gains with a withdrawal provision would pass through to the beneficiary, without speaking at all to how any net *losses* should be treated. IRC §678 and Treas. Reg. §1.671-3(a)(1) are clear that once the beneficiary is deemed the owner, ALL income, deductions and credits pass through to the deemed owner, *including* losses, but it is not clear whether or when a powerholder would be deemed to be the owner when the only “power” remaining is to vest negative income (a loss) in themselves – there is no clear guidance:

“§678(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”

§1.671-3(a)(1):“If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (*including capital gains* ***and losses***) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.”

This situation will thankfully not come up very often – only in years with extraordinary losses. While there is an argument that the loss equally passes though pursuant to the regulation above, it is hardly a slam dunk and it is probably safest to assume that the capital loss in excess of capital gains will ***not*** pass through. If we try to glean some guidance from the world of Subchapter J, Parts A-D (ordinary non-grantor trust taxation), we know that even if we come under one of the exceptions to allow capital gains to pass out to beneficiaries (discussed extensively in the next section) capital losses are only part of DNI (distributable net income) to the extent they offset capital gains, except in a final year of termination when they can pass out to beneficiaries.[[427]](#footnote-428)

There are two methods around this uncertainty: first, avoid substantial capital losses beyond capital gains inside the trust in the first place by distributing substantial loss property in kind. For example, let’s say the trustee invests a quarter million in a high-flying stock that doesn’t pan out – the $250,000 investment tanks to $50,000. If the trustee transfers this stock in kind pursuant to a distribution power, because the trust would be a non-grantor trust taxed under Subpart A-D over at least a portion, the distribution is deductible to the trust and carries out income under IRC § 661/662 to the extent of the basis and any DNI, not to the extent of the FMV ($50,000, not $250,000), pursuant to IRC §643(e)(2), with the beneficiary taking the property with a carry over basis. Alternatively, the trustee (or trust protector) might have the authority to grant the beneficiary the right to withdrawal the stock itself. Either way, the basis carries over and the beneficiary can sell the stock for a $200,000 capital loss (perhaps offsetting their own personal capital gains in current or future years) – either of which is potentially more advantageous than had the loss been trapped in trust (especially if the trust is not subject to state income tax but the beneficiary is).

Secondly, one can build in a fail-safe clause to reduce the future years’ withdrawal rights over capital gains by the amount of prior net losses so that the beneficiary does bear both the fruits and the burdens of capital gains and losses. That may be persuasive in helping to conclude that §678(a)(1) should still apply to shift the net loss to the beneficiary. However, to the extent it does not, any net unwithdrawable gains in that future year in which the withdrawal right is reduced would be taxed under Subchapter J, Parts A-D (ordinary non-grantor trust), and the losses previously held in abeyance would then be able to offset the gains in that year. Therefore, even in a worst-case scenario, a net capital loss would be treated no worse than a net capital loss in an ordinary irrevocable non-grantor trust taxed under Subchapter J, Parts A-D. For example, if in our $200,000 capital loss example the IRS concludes it must be reported by the trust under Subchapter J, Parts A-D, rather than the power holder under §678(a)(1), and the next year’s trust income is $50,000 dividends/interest and $250,000 capital gains, the net withdrawal amount in the subsequent year would be reduced from $300,000 to $100,000, with the trust then reporting a $200,000 gain offset by the prior year’s $200,000 capital loss carryforward – a wash.

While §678(a)(1) withdrawal provisions shift the income taxation (and with it, the Medicare “surtaxation”),[[428]](#footnote-429) such powers bring up other minor 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 (cessor) clause and/or trust protector might easily cut that off to prevent much ongoing damage, since only the year’s accumulated income would be at risk, which frankly is not much worse than other trusts, since bankruptcy pulls in recent trust distributions regardless. An automatic provision is preferred to avoid fraudulent transfer issues, but a trust protector enables modification when no threat is imminent.[[429]](#footnote-430)
* slightly increased estate inclusion risk (amounts subject to withdrawal at death are in a beneficiary’s estate), but again, this can be largely mitigated so that the withdrawal right is not vested and active until the end of the year. A beneficiary would be unlikely to die with any includible right, it would be minimal, and in many cases there would be a testamentary GPOA causing inclusion anyway (as discussed in Part III of this paper).
* 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 unspent amounts to an IRA/Qualified Plan, cash value life insurance, LLC, irrevocable gifting trust, homestead, self-settled asset protection trust or other protective structure.

Most tax preparers (and attorneys) are neither educated on these concepts nor prepared to evaluate such trusts, so if §678(a) provisions are added, add an explanatory sentence or two (in bold or right in the withdrawal provision, not buried in the boilerplate) describing the intention of the clause and its intended tax effect to alert trustees and their advisors. Statements of intentions may also help with any future reformations.

1. ***IRC §678(a) – Seizing the $250,000 capital gains tax exclusion for residence under §121***

The most common of the tax savings opportunities for a grantor trust to encounter, applicable to the sub-$5.45 million dollar estates as well as the wealthiest, is the capital gains exclusion on the sale of a principal residence. A provision to withdraw capital gains from the sale of a residence, as discussed above, creates a §678(a)(1) trust as to that asset upon sale. Such a provision as to residential property, but not other assets, avoids many of the negatives of §678(a)(1) trusts. 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.

Grantor trusts are permitted this exclusion provided the other occupancy requirements are met.[[430]](#footnote-431) A non-grantor trust is ***not*** eligible for the $250,000/$500,000 capital gain exclusion on the sale of a personal residence provided by §121, but §678 trusts are specifically included in the regulations.[[431]](#footnote-432) *A mere right to occupy and use the property is insufficient* to cause grantor trust status necessary for the §121 exclusion. If the trust is partially a grantor trust, such as a trust with a five and five power, then the grantor may exclude that portion of the gain.[[432]](#footnote-433) Of course, the goal with this type of provision would be to grant the withdrawal right over the capital gain from the sale, not the income – and not tied to 5% of corpus. The portion rules, remember, can be tied to specific assets.

This is no small benefit – with federal long-term capital gains rates at 23.8%, the effect of Pease limitations at approximately 1.2% for itemizers, the phase out of personal exemptions, effect on social security taxation and other deductions/credits, indirect effect on alternative minimum tax, and state and local income taxes at up to 13.3%, there could easily be a tax cost of $100,000 if this $250,000 tax exclusion is lost.[[433]](#footnote-434) The exclusion is double for up to two years after death, but more important for the long term, *surviving spouses often remarry*![[434]](#footnote-435) If their new spouse meets the two year occupancy requirement, hasn’t used the provision themselves in the last two years and they file jointly, the exclusion is doubled, even if only one spouse is deemed the owner, through §678, of 100% of the trust income.[[435]](#footnote-436) Thus, losing this tax break could easily mean **$500,000** of avoidable long-term capital gains income. When we consider the remarriage scenario for those living in states with a separate income tax, we’re getting **close to a potential $200,000 income tax effect**. Have fun explaining that to the surviving spouse if it’s lost.

Trustees must normally make property productive of income, but trusts routinely permit the trustee to invest in or retain a contributed residence for a beneficiary and specific language should be considered on this point.[[436]](#footnote-437) The QTIP marital deduction, of course, permits a surviving spouse’s use of a residence to qualify for the marital deduction, provided the spouse is entitled to any rental income if the property is later vacated as a residence.[[437]](#footnote-438)

There are other income tax traps when a residence used by a beneficiary is owned and maintained by the trust. The amounts spent by the trustee to maintain the residence *are generally not deductible and not considered to have been distributed to the beneficiary*.[[438]](#footnote-439) Trustees can easily botch this accounting. Even if this is reported correctly, it may lead to more trapped and taxed in trust than necessary, as opposed to the greater simplicity of simply making distributions and letting the beneficiary pay.  The mortgage interest deduction should be allowed to the extent paid by the beneficiary.[[439]](#footnote-440)

The beauty of this more limited provision of permitting withdrawal of the capital gains from the sale of the residence is that it has NO effect on the grantor/non-grantor trust status of the trust until such time as the withdrawal right is triggered (upon sale), simplifying reporting. When the trust reverts back to a fully non-grantor trust, the distribution provisions can simply take into account any earlier distribution of capital gains from the sale of the residence as part of the surviving spouse’s available resources or as a factor that might reduce future distributions accordingly (keeping the mandatory income floor if it is a marital trust).  

1. ***Application to Special Needs Trusts, Medicaid qualification***

It is probably stating the obvious, but a §678(a) power would not work in a special needs trust scenario – the trust would be considered a countable resource to the beneficiary. 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.[[440]](#footnote-441) If the original grantor is still living, grantor trust status for these work well, but it’s probably best to stick to ordinary non-grantor status upon the death of the original grantor for such trusts.

1. ***Application to 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.[[441]](#footnote-442) 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 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 (W-2, 1099), 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.

1. ***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 from engaging in installment sales, swaps or other transactions with their fully §678(a)(1) trusts under Rev. Rul. 85-13 and its progeny?[[442]](#footnote-443) Isn’t this similar to an installment sale or swap with a *BDIT* (which relies on *lapses of powers over the entire* ***corpus*** per §678(a)(2)), but with an unlimited seed gift, rather than a mere $5,000, and with less attendant substance over form risk accordingly? 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? Isn’t this safer than a beneficiary sale to a qualified subchapter S trust (QSST), which is only a grantor trust as to the income rather than the entire corpus if the S corporation stock is sold? Comparing §678(a)(1) “beneficiary income controlled trusts” transactions with installment sales to BDITs, QSSTs and other grantor trusts will be considered in a separate article. To summarize, however, the only difference between a beneficiary deemed owner trust with a §678(a)(1) withdrawal right over only taxable income and one the uses a §678(a) withdrawal right over the entire corpus or some other grantor trust trigger is the possible uncertainty in a year in which there are capital losses that are not offset by capital gains, as discussed in paragraph c above.

1. **Using Treas. Reg. §1.643(a)-3(b) to Permit Capital Gains to Pass to Beneficiary**

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 to the extent of distributions. So, how do we get out of the default rule that capital gains are not ordinarily part of DNI?[[443]](#footnote-444) 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”.[[444]](#footnote-445) The regulations regarding these exceptions are relatively short and merit full inclusion here:[[445]](#footnote-446)

“(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 might even give some cover in case the trustee failed to be consistent.[[446]](#footnote-447) For new estates and trusts, this is quite easy. For an existing trust, it probably cannot change this practice when in prior years it has been consistently NOT treating capital gains as part of a beneficiary’s distribution.[[447]](#footnote-448) The IRS is rather stringent interpreting this paragraph.[[448]](#footnote-449) Potential remedies of amendments and decanting will be further discussed below.

The third method, (b)(3), is slightly 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 if a loan/mortgage had to be paid off?

In lieu of tracing, the third method also allows capital gains to be part of DNI if the trustee, “pursuant to a reasonable and impartial exercise of discretion” 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 where gains determine the amount “required to be distributed”. 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).

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 in my discretion 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 the regulation only requires “utilization by the fiduciary”, not any required mandate in the document.[[449]](#footnote-450) One could argue that common law fiduciary duties of prudence would permit the trustee to consider gains as a factor. However, it would be more certain if the trust document specifically required or at least expressly permitted the trustee to consider capital gains.[[450]](#footnote-451) A non-judicial (private) settlement agreement is a good solution here to add such a sentence, since this is not the kind of drastic change that would require a court reformation.

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 discretionary 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.”[[451]](#footnote-452)

Thus, in theory, not only could capital gains be allocated to income, but it can be done at the trustee’s discretion. Most states have default principal/income rules that allow a trustee to make adjustments to income and principal, *in theory*.[[452]](#footnote-453) 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 UPIA §§ 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).[[453]](#footnote-454)

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 capital gains becomes part of DNI and any distribution can then carry out capital gains just like other income on the K-1 to the beneficiary, taxed at her much lower rates.[[454]](#footnote-455)

1. ***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, where it’s unlikely that the parties would want to change the scheme (e.g., if the beneficiary is anticipated to be in a high tax bracket and high state income tax state but the trust is not a resident trust of a high tax state, then perhaps it’s more tax efficient to trap capital gains in trust). It’s doubtful that decantings or other amendments can successfully change the method once set in place – if such be the case one of the other methods would be preferred.

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 much easier, and is promising if the trust has language requiring consideration of capital gains in the distribution decision. In contrast to (b)(2), it does not require the trustee to be “consistent” in its treatment of capital gains as part of DNI.

There are certainly unanswered questions about how far trustees can push the envelope – would the IRS ever argue that the trustee is not being “reasonable and impartial”, as required under all three methods? Would the IRS ever scrutinize and police how the trustee is “utilizing” capital gains as a factor in discretionary distribution decisions? Since fiduciary income tax returns have the lowest audit rate of any income tax return, it’s unlikely we’ll get clear answers soon, if ever, but also extremely unlikely the IRS would ever take up that banner with so many more cases easier to win and more abusive tax schemes to battle. After all, Treasury gave extremely wide latitude to trustees with these regulations.

1. ***Issues 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 the new treatment of capital gains as *inconsistent* with prior practice. After all, trustees don’t typically get a completely new EIN for such changes, and it’s unclear whether it would matter if they did. Because of this substantial uncertainty, practitioners dealing with a preexisting trust with a history of not treating capital gains in such a manner should probably use one of the other two methods mentioned above.

1. ***Impact of changing tax burden on beneficiary distributions***

Going back to our earlier example, if capital gains are considered part of Barbara’s distribution and ordinary non-grantor trust rules are applied, not only the $40,000 of accounting income but the $75,000 of principal distribution is also taxed to her. 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 $12,400. Thus, the 43.4%/23.8% highest marginal trust tax rates are 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 ($95,000 x 23.8% = $22,610, approx.), 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.

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” and ensure the IRS finds “reasonable and impartial” use of discretion 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, much 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 process. In the latter cases, a professional and independent trustee or co-trustee should be considered to properly exploit this flexibility. Regulated trustees HAVE to paper the file, for the Office of Controller and Currency (OCC) or state auditors and internal accounting committees, with their considerations for discretionary decisions.

1. **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.[[455]](#footnote-456) Or, probably better in many ways, the settlor may give the surviving spouse and/or another party a limited lifetime power of appointment.[[456]](#footnote-457) 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 if there is a spray power or asks a collateral power holder if someone else has a lifetime power, to distribute $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.[[457]](#footnote-458) 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 would suggest using separate trusts or subtrusts).[[458]](#footnote-459) 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.

1. **Why marital trusts are usually terrible for tax shifting and what can be done**

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. But there is a distinct difference between QTIP and GPOA marital trusts.

Without looking at other regulatory guidance, the tax code seems to allow such a power for GPOA marital trusts but disallow it for QTIPs:

IRC §2056(b)(5):

“Life estate with power of appointment in surviving spouse. In the case of an interest in property passing from the decedent, if his surviving spouse is entitled for life to all the income from the entire interest, or all the income from a specific portion thereof, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the entire interest, or such specific portion (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), *and with no power* **in *any other* person** to appoint any part of the interest, or such specific portion, *to any person other than the surviving spouse*;”

IRC §2056(b)(7)(B)(ii):

“(ii) Qualifying income interest for life. The surviving spouse has a qualifying income interest for life if—

1. the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and
2. ***no person*** *has a power to appoint any part of the property to any person other than the surviving spouse*.”

So it appears from the code that a marital GPOA trust permits a spouse to appoint to themselves or others with a presently exercisable general power of appointment but a QTIP cannot. Revenue Rulings and TAMs have also approved of a marital GPOA trust permitting a spouse to appoint to others.[[459]](#footnote-460)

By contrast, a 1989 PLR had permitted a QTIP trust to qualify despite a “five and five” lifetime general power to appoint to the powerholder or others, but it is unclear whether such a PLR would be granted today in light of more recent treasury regulations failing to clarify the point.[[460]](#footnote-461)

An unexercised 5/5 power ordinarily is an unholy nightmare to administer and track, because every lapse creates a changing fractional grantor trust.[[461]](#footnote-462)

Let’s return to a modified version of our previous example, but with a marital GPOA trust: Barbara’s **marital GPOA trust** grants her the power to withdraw all net income, plus she has a 5/5 power and testamentary general power of appointement. The trust corpus is $2 million and has ordinary income of $40,000 (the trust’s accounting income), short-term capital gains of $30,000, and long-term capital gains of $70,000. The trustee does not allocate capital gains to trust income.

Barbara is taxed on $40,000 ordinary income directly under §678 by virtue of her power to withdraw the accounting income, which is necessary to qualify as a marital trust. She is also responsible under §678(a) for 5% of the capital gains income attributable to corpus ($100,000 times 5% = $5,000). The remaining income ($95,000) is taxable to the trust, except to the extent that Barbara decides to actually appoint up to 5% ($100,000) to others. Barbara appoints (orders the trustee to distribute) $100,000, which is 5% of the corpus, to her children, who are in lower tax brackets. Ordinary Subchapter J (Parts A-D) principals apply to the non-grantor portion of the trust. Provided that the trustee uses one of the two §1.643(a)-3 exceptions noted in Part VIII.g. that permit such distributions to be included in DNI, [[462]](#footnote-463) the trustee must send a statement with the Form 1041 apprising Barbara of her income under IRC §678 of the grantor trust rules and must file K-1s for the $95,000 in capital gains distributed to her children, who may be in a 0% LTCG or 15% STCG tax bracket. 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’s transfer would be a taxable gift for the $100,000 transferred due to IRC §2514 – 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 ($100,000-$45,000 annual exclusion gifts). For many taxpayers, this would not be a big deal, since with DSUE the survivor may have over $22 million of applicable exclusion amount. The income tax savings would often be worth it.

In conclusion, adding a 5/5 PEG power to a GPOA marital trust does work to permit tax shifting and better charitable deductions to the extent appointed. This may work with a QTIP but is much more uncertain – don’t overpromise or get a PLR like PLR 8943005. Why not just use a bypass trust (optimal basis increase), which can get most of the advantages of a QTIP, with much more certain and more robust ongoing income tax advantages?

1. **IRC § 642(c)** – **Seizing better charitable deductions through trusts**

In many respects, IRC §642(c) offers better deductions for trusts and estates than individuals receive. The trust can effectively take “above the line” charitable deductions up to the entire gross taxable income, not subject to 20%/30%/50% AGI limitations.

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..[[463]](#footnote-464)

Furthermore, unlike individuals, and even better than a 65 day election, a trustee can 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 relief to file late under Treas. Reg. §301.9100-3.[[464]](#footnote-465)

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.[[465]](#footnote-466) Pease limitations do not apply.[[466]](#footnote-467) Charitable contributions can come from and carry out capital gains allocated to corpus.[[467]](#footnote-468) They can carry out IRD.[[468]](#footnote-469)

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 severely limit it. Other states allow individual charitable deductions, but they are subject to Pease limitation-like phase outs.[[469]](#footnote-470) By contrast, most states’ ***trust*** tax regimes start with the taxable income number from federal Form 1041, line 22, which is calculated *after* the §642(c) deduction.[[470]](#footnote-471) Saving another 5-10% state income tax can be substantial state income tax savings, especially if there is state-source income, like selling a business or real estate located in state, that cannot otherwise get around state income tax.[[471]](#footnote-472)

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.

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.”[[472]](#footnote-473) 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.[[473]](#footnote-474) This is not possible with charitable lead trusts (CLTs) because of the fixed unitrust or annuity obligation, which destroys any chance for an ordering rule to have economic effect, but it is still viable for non-charitable trusts. For instance, if the trust limits the charities’ potential distribution (powerholder’s annual limited power to appoint) to income from net *short-term* capital gains, taxable interest, taxable retirement plan distributions 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 capped and dependent upon the short term capital gains, taxable interest and rents the trust earns within that taxable year.[[474]](#footnote-475) Therefore, going back to our example with a charitable limitation with “economic effect”, the donor advised fund in our example would not receive any long-term capital gains (LTCG), qualified dividend (QD) 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, and the tax exempt income, while the charity gets the ordinary income otherwise taxed at up to 43.4%

Another way to maximize the charitable tax deduction against the highest rate income with the more advantageous §642(c) deduction, while the settlor is still living, is to establish a part grantor, part non-grantor trust. The accounting income could go to charity, and the capital gains (or other income allocated to principal) could be taxed to the grantor. Think of it as a non-qualifying part grantor, part non-grantor charitable lead trust. Such a trust would receive an “above the line” charitable deduction for any proceeds from the non-grantor accounting income portion (typically dividends, interest, rent and pass through income from a partnership/LLC, but this could include short-term capital gains) that are distributed to charity. All but qualified dividends are typically higher rate income. Meanwhile, the grantor could then receive and be taxed on the income allocated to principal, typically long-term capital gains, taxed at advantageous rates.[[475]](#footnote-476)

The IRS is surprisingly lenient when it comes to allocation of the charitable deduction when there are other non-charitable discretionary beneficiaries receiving distributions. 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*.[[476]](#footnote-477)

Furthermore, a distribution pursuant to a lifetime limited power of appointment may also qualify for the IRC §642(c) deduction.[[477]](#footnote-478) 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 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).[[478]](#footnote-479)

What if the court, trustee, trust protector or parties, through reformation, decanting or non-judicial settlement, amend the governing instrument to allow the distribution? It seems logical under the statute that if this new agreement is *now the valid governing instrument under state law*, it *should* be allowed – but it will likely be unavailable as to any contributions made prior to the reformation, and the IRS may even fight or deny its impact prospectively.[[479]](#footnote-480) One recent tax court case illustrates this important distinction: in *Harvey C. Hubbell Trust v. Comm.*, the trustee of a long-term testamentary trust had for years been making charitable contributions from a trust without objection from beneficiaries (the tax year in question was 2009), despite the fact that the charities were not yet entitled to distributions of income.[[480]](#footnote-481) In 2014 (it is unclear whether this was before or after instigation of audit), the trustee went to the Hamilton County Probate Court in Cincinnati, Ohio and succeeded in having the court declare as follows:

“The language of the Will, as written, providing for the administration of the Trust, authorizes, *and has from the inception of the Trust authorized*, the Trustees of the Trust to make distributions of income and principal for charitable purposes specified in Internal Revenue Code section 170(c), or the corresponding provision of any subsequent federal tax law, both currently and upon termination of the Trust.”

Too late! While the local probate court was happy to oblige the trustee and beneficiaries with the requested relief, the tax court was quick to point out that the Will was hardly ambiguous – it had no mention of any charitable beneficiaries or authorization to distribute to any charities whatsoever. Accordingly, they gave no weight to the local court’s construction of the will/trust and refused to honor any retroactive tax effect of such a court-ordered amendment for §642(c) purposes. The tax court did *not* address, however, what tax effect the probate court’s amendment would have on contributions made *after* the reformation – those are substantially different issues that were not yet before the court.

A recent IRS Chief Counsel Advice Memorandum which had very similar facts (and is very likely related to the *Hubbell* case), echoed the same conclusions, and, without much analysis, determined that “any payments to Foundation 1 and Foundation 2 *after the modification* of Trust B would not be considered to be made pursuant to the governing instrument, and Trust B is not entitled to a deduction for such payments under § 642(c).”[[481]](#footnote-482)

Another recent PLR denied the *prospective* tax effect of an attempted trust reformation in a similar instance: in PLR 2014-38014, the parties obtained a state court reformation to qualify the Trust for a charitable deduction under § 642(c), so that IRA distributions could go to charity from a trust and qualify for the deduction (the original trust contained a pecuniary bequest).[[482]](#footnote-483) The IRS ruled that:

“Neither Rev. Rul. 59-15 nor *Emanuelson* hold that a modification to a governing instrument will be construed to be the governing instrument *in situations where the modification does not stem from a conflict*. Additionally, both *Crown Income Charitable Fund and Brownstone* have a narrow interpretation of what qualifies as pursuant to a governing instrument. \*\*\*because the purpose of the court order reforming Trust was to obtain tax benefits rather than resolve a conflict, the Internal Revenue Service will not respect Trust's reformation.”

PLR 2014-38014 and CCA 2016-51013’s conclusions above are somewhat dubious in light of Rev. Rul. 73-142 and other precedent noted in Part VII of this paper – reformations done primarily for tax purposes are no different than trusts established for tax purposes - if they are valid they are valid and should be considered the governing instrument *prospectively*. However, these rulings and the *Hubbell* and *Brownstone* cases shed a substantial amount of uncertainty as to the tax effect of any substantial reformations completed *for §642(c) qualification*, even prospectively, so manage your client’s expectations accordingly.[[483]](#footnote-484)

What if the trust has no provision to make distributions to charity, but an FLP/LLC partially owned by the trust makes the contribution from *its* gross income through *its* governing instrument, and the contribution passes to the trust via K-1? Surprisingly, the IRS will permit this and even issued a revenue ruling, which also opens up further opportunities to exploit §642(c).[[484]](#footnote-485) This is true even for the one of the most stringent taxpayer-unfriendly areas of the tax code – the electing small business trust (ESBT) – regulations allow the §642(c) deduction when the S corporation itself makes the contribution.[[485]](#footnote-486) While the rules for passing through the 642(c) deduction are lenient for pass-through business entities, such contributions cannot pass through trust or estates – an important point to remember in exercising any decanting.[[486]](#footnote-487)

While I may disagree with the logic of CCA 2016-51013, establishing a pass through entity owned in part by the trust to make charitable contributions appears more certain to qualify for §642(c) than modifying the trust instrument itself.

One unique aspect to §642(c) was not discussed in the PLRs, 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 with a basis of $100,000 valued at $140,000 (even if it distributes 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.[[487]](#footnote-488) It cannot come from tax-exempt income such as municipal bond interest or a Roth IRA distribution.

This concept extends to distributions in kind. While the charitable contribution from a trust need not be in cash, any property must be traceable to gross income and basis may still be relevant. So, if the trust had purchased Blackacre for $80,000 (traceable to gross income) and Blackacre had appreciated to $100,000 by the time of distribution to charity, there is substantial uncertainty whether the deduction under IRC §642(c) is limited to $80,000, since only $80,000 came from gross income, or the full $100,000. The IRS believes that it should be limited to $80,000 – that unrealized capital gains should not be added to the deduction.[[488]](#footnote-489) They are probably right, and were just backed up in a circuit court opinion.[[489]](#footnote-490)

Another minor negative of the §642(c) deduction is that excess deductions cannot be carried forward or used by another beneficiary, even upon termination of a trust or estate. In one case, a residuary beneficiary of estate tried to use the estate’s excess charitable deduction and personal exemption that the estate could not use on their personal return, similar to how many other excess deductions pass through on an estate/trust termination pursuant to IRC §642(h)(2) – the tax court denied their deduction, holding that unlike other losses/deductions, such unused deductions do **not** pass out upon termination.[[490]](#footnote-491)

Another hurdle is that the use of §642(c) is sometimes 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. [[491]](#footnote-492) However, this does not mean that the deduction is eliminated – it may not be reduced at all, and it may depend on where the charitable distribution goes (e.g. to a public charity or a private foundation).[[492]](#footnote-493) A few simple examples are helpful (all assume **cash** contribution, not appreciated property):

* 1. A trust has $91,000 of income via K-1 from an LLC/partnership conducting a business and only $9,000 of other income ($100,000 total). The “quasi-UBTI” before the charitable deduction allowed under §512(b)(11) would therefore be $90,000 ($1000 is subtracted as deduction per §512(b)(12)). If the trust makes a distribution of $50,000 to a public charity that would qualify under §642(c), the portion allocable to “quasi-UBTI” is 9/10 or $45,000 ($90,000 UBTI/$100,000 total income). The amount disallowed for a deduction is this amount, $45,000, minus what would have been allowed as a charitable deduction against UBTI under §512(b)(11), 50% times $90,000 ($45,000), so **NONE** of the §642(c) deduction is disallowed per §681.
  2. Same as above, but instead the trust distributes $100,000 that would otherwise qualify for §642(c) deduction. The calculation is similar, with $90,000 UBTI before any §512(b)(11) deduction. The portion of the $100,000 allocable to “quasi-UBTI” is 90% ($90,000 UBTI/$100,000 total income), or $90,000. The amount disallowed by §681 is $90,000, minus what would have been allowed under §511(b)(11), again the same as above, $45,000, so **$45,000** of the §642(c) deduction is disallowed.
  3. Extrapolating some general rules from these two examples, the more non-UBTI income in the trust and/or smaller the charitable deduction, the less we have to worry about §681. If instead of to a public charity, the $50,000 in example #1 went to a PRIVATE foundation, the amount allowed under §511(b)(11) would only be **30%** of $90,000, or $27,000, leaving $18,000 disallowed under §681 (in example #2, increasing disallowance to $63,000). Thus, at the margins where there is high % of UBTI and high deductions as % of income, it will matter whether the charitable distribution goes to a private or public charity. For example, if the non-UBTI were slightly higher, $109,000, in our example #2 above, the portion allocable to UBTI would be half (45% in lieu of 90%), $45,000, minus the amount that would be allowed under §512(b)(11), $45,000, meaning again, NONE of the §642(c) deduction is disallowed.

As an aside, this quirk in §512 may be a good reason to favor trusts as the governing agreement for private foundations that might receive significant UBTI rather than using the corporate form. Even if the UBIT tax rate is higher for trusts than corporations, the §512(b) offset is better for trusts.[[493]](#footnote-494)

One could curtail the scope of a lifetime power of appointment or spray power to charity to exclude this “quasi-UBTI” altogether, but this is probably not warranted in most cases (see various sample language examples in appendix). For instance, if a trust is funded with 95% LP/LLC interests kicking off UBTI, limiting the charity to only receiving non-UBTI effectively eliminates the ability to make any meaningful charitable donation. Whereas, §681/§512 would still allow a significant, if not all, portion as a deduction. The unique provisions regarding the §681/§512 haircut may be a reason to favor public charities as recipients of such income, at least at the margins.

Lastly, whenever using the §642(c) deduction, be aware that you may have an additional tax return filing requirement. Filing Form 1041-A is required not only for certain split interest trusts such as charitable remainder trusts, but also for ordinary irrevocable non-grantor trusts that are not required to pay all net income annually, that make distributions to charity claiming a §642(c) deduction.[[494]](#footnote-495) Since the trend in drafting trusts is to avoid “all net income annually” trusts to enable better asset protection, accrual of tax benefits, state income tax avoidance and/or tax shifting, as discussed throughout this paper, it would not be odd to run across this requirement.

Despite the above points to watch out for, with all the above tax planning ideas, we have the *Holy Grail* of income tax planning – the ability to trap income in trust if state tax savings can be had, to spray income to lower bracket beneficiaries, and get “above the line” charitable deductions that can reduce the Medicare Surtax and avoid Pease limitations (including in many cases, even receive 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!

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 and the use of inter-vivos non-grantor trusts and even oddly enough, part-grantor, part non-grantor trusts.

1. **DINGs, NINGs, OINGs – Not just for STATE income tax avoidance**

***(or, How to get a tax deduction for annual exclusion gifts to your kids)***

Practitioners might consider not only embedding such strategies into bypass or other trusts established at death, but in some cases might actively use such flexible provisions in intervivos non-grantor trusts for better income tax planning (both state and federal). 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-grantor trust with §642(c) provisions that does not qualify as a CLT, instead of a CRT or grantor CLT.[[495]](#footnote-496)

Let’s start with a DING example that does not even rely on state income tax savings.[[496]](#footnote-497) 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. 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% 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 non-IRA investments to a DING 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 Form 1040, to the Form 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.[[497]](#footnote-498) Not only that but many taxpayers, even many higher income taxpayers, do not even itemize deductions.[[498]](#footnote-499)

Would a family bother with a trust to get $10,000 tax savings annually? Perhaps not for that alone, but there are various other reasons, including state income tax. 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%). Shifting income to a trust may also preserve other tax credits/deductions from phase out, such as itemized deductions, AMT exemption, or personal exemptions.

Of course, the above example does not even contemplate potential state income tax savings, which is touted as the primary benefit of DINGs. This paper will not discuss dozens of states’ income tax laws – see the various compiled state charts and separate outline.[[499]](#footnote-500)

1. **The DING-CRUT and Other Non-Grantor Trusts Contributing to CRTs**

Most readers are familiar with using charitable remainder trusts (“CRTs”) to defer taxation. A CRT itself is tax exempt, but payments back to a settlor/grantor may be taxable under a 4-tier ordering system (perhaps even 100% of the distribution in early years), so it's more accurate to claim that it *defers* rather than avoids the tax (provided the beneficiary lives long enough to receive enough back, if it is a lifetime CRUT). So, CRUTs are often recommended to defer gains on an anticipated sale of appreciated property (as long as the transfer is done before the contract for sale is a “done deal”).[[500]](#footnote-501)

DINGs often cannot get around "source" income (in-state real estate, closely held in-state LLC/LP/S corps). However, C corporations are not *source income* to any one state. Taxation of the sale of such stocks (and depending on the state, often pure stock sales of LLCs/S corporations as well) typically follow the domicile of the owner, under the legal theory of *mobilia sequuntur personam.[[501]](#footnote-502)* Thus, these mergers create a perfect candidate for using either DING trusts to avoid state income tax for higher bracket taxpayers, or CRUTs to defer federal tax. Or both.

CRUTs can be combined with a DING to defer the federal taxation until payment, avoid state taxation of the payment and even permit more optimal tax shifting and charitable deductions for any shifting of the subsequent payment. The DING can be the beneficiary of the CRUT. There is no prohibition on a non-grantor trust or other entity being an income beneficiary of a CRT.[[502]](#footnote-503) This would have to be a term, not lifetime, CRUT, of up to 20 years.[[503]](#footnote-504)

This may allow the best of both worlds - defer the federal tax, and avoid the state income tax. In contrast to a term CRT naming a child/grandchild as beneficiary, which creates a lump sum taxable gift upon creation, this method could use the annual exclusion for any annual gifts coming from the DING to the children.

Even more intriguing, a CRUT can be the beneficiary of the DING (or any other non-grantor trust or estate provided the document so permits), or more accurately, a CRUT can be a permissible appointee receiving funds by direction from the distribution committee’s lifetime limited power of appointment (an exception, of course would be S corp/ESBTs, which for various reasons will not work with this structure).

In PLR 9821029, a Settlor created the Trust to hold, manage, invest, and reinvest the Trust's property for Beneficiary, an adult with no living descendants. Beneficiary held the lifetime power to appoint any part or all of the Trust's principal to any one or more of his living descendants and any charitable organizations in trust or otherwise. The beneficiary proposed appointing to a CRUT for a 20-year term, with the trust receiving 5-50% unitrust and the charity receiving at least a 10% actuarially determined interest. The IRS found that nothing prohibited a non-grantor trust from being both a donor and recipient of a CRUT. [[504]](#footnote-505)

In an IRS general counsel memorandum, the IRS clarified and concluded that an estate (or non-grantor trust) would be entitled to a deduction under IRC 661(a) for amounts distributed to the charitable remainder trust (up to DNI of course).[[505]](#footnote-506) To quote a few key passages: “

Section 661(a) provides, in general, that an estate may deduct any income, not to exceed the estate's distributable net income, that was properly paid or credited or required to be distributed within the estate's taxable year. This section, in conjunction with IRC 643 and 662, implements the "conduit theory" of estate taxation, under which the income of an estate is "passed through" to the beneficiaries of the estate, and the beneficiaries must include the income which they actually receive or have a right to receive in their gross income.\*\*\* Therefore, the trust is considered to be a beneficiary of the decedent's estate.\*\*\* Since we have concluded in our discussion of Issue (1) that no amounts distributed to the charitable remainder trust in this case are considered as set aside for charitable purposes within the meaning of section 642(c)(2) of the Code, the prohibition of Treas. Reg. 1.663(a)-2 on section 661 deductions for amounts paid or set aside for charitable purposes has no application in this case. Thus the estate is entitled to a deduction under section 661 of the Code for its distributions to the trust, up to the amount of the estate's distributable net income.

These provisions operate no differently where the beneficiary is tax exempt, as is a charitable remainder trust under section 664(c). In particular, section 661(a) does not require that a distribution be made or required to be made to a taxable beneficiary in order to be deductible under that section. The only requirement of section 662 is that the beneficiary include the distributed amount in its gross income. A charitable remainder trust is required, under IRC 6034, to file returns. Forms 5227 and 1041-A (if the trust has any unrelated business income) have been promulgated by the Service for, inter alia, a fiduciary to report the gross income of the trust. Additionally, when the charitable remainder trust distributes income to the income beneficiary, the income maintains its character as ordinary income. IRC 664(b)(1).”

Thus, it should be clear from above that while there is no charitable income tax deduction permitted for a contribution from a non-grantor trust or estate to a CRT, there is a garden variety income distribution deduction. For certain situations, this is actually more valuable – particularly where the contribution to a CRT would comprise of anything but low basis assets. From a tax deferral perspective, an individual’s contribution to a CRT is more inefficient the higher the basis of the assets contributed, because one the deferral is less. For example, the tax deferral saved by contributing a $1 million, $0 basis asset will be much greater than the tax deferral saved by contributing a $1 million, $900,000 basis asset. “Crunching the numbers”, depending on the growth and tax rate assumptions, families will almost always be better off financial by selling a high basis asset and paying the tax than by contributing the asset to a CRT. By contrast, when the basis is below 20% or so, the value of the deferral to the unitrust beneficiary can often make up for the fact that the charity is getting an actuarial value of at least 10% of the contributed corpus (again, this depends on several factors such as assumed investment returns, how long the settlor/spouse live, etc.).

While the chart below is comparing the use of an incomplete gift non-grantor trust, the comparison and general principles hold equally true when comparing any other non-grantor trust. Contributing through a non-grantor trust or estate enables much more efficient tax deferral than an ordinary CRUT, which can only offset, under the best case scenario, the actuarial value of the charity’s interest via Schedule A deduction, as opposed to the entire amount.

For more details on this technique using incomplete gift non-grantor trusts, see the author’s separate presentations on this subject.[[506]](#footnote-507) Consider the following chart which illustrates the potential effect over 21 years of several tax planning techniques involving the sale of a $10 million property with $4 million basis, half of the gain being §1250 recapture, with subsequent post-sale return on investment net of expenses of 7.5%, using a 20 year CRUT with a minimized charitable interest (approx. 10%), state income tax rate of 9.9% and top federal rates of 20% LTCG, 25% §1250 recapture and 3.8% net investment income tax.

**Does the “Character” of Income as UBTI Pass Out on K-1 to Beneficiaries when the Distribution Qualifies for the Deduction under IRC §661 rather than §642(c)?**

This is a vexing but extremely important question to address in planning for any transfer to a CRT from a trust or estate if it holds any business interests. No treatise I have found discusses the issue very well nor has a firm opinion or citation. Someone has to take a stand! So, with the caveat that I may be the lone attorney on the planet to have this firm opinion, let’s explore why this question is important, state the arguments and stake an opinion: *amounts passing from an estate or trust to charitable remainder trust are* ***not*** *UBTI, even if some of the income on the K-1 would have been UBTI had it been received by a charity directly or through ownership of a partnership or S corporation*.

Being confident in this conclusion is crucial if any business sale or income is involved, because UBTI is taxed at 100% rate for CRTs![[507]](#footnote-508) What if an estate or trust sells some S corporation stock (which would be UBTI if sold by a charity) and then happens to make a contribution to a CRT in the same year?

The reason why the question is confusing to many practitioners is that the general rule for distributions carrying out income to beneficiaries is that the ***character*** of the income flows through to the beneficiary. IRC §662, which governs the inclusion of amounts in gross income of beneficiaries of estates and trusts accumulating income or distributing corpus, lays this out as follows:

**“(b) Character of amounts**

The amounts determined under subsection (a) **shall have the same *character* in the hands of the beneficiary as in the hands of the estate or trust**.

\*\*\*\*\*\*\*\*\*

The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust.”[[508]](#footnote-509)

So, is unrelated business income a “character” of income that becomes “unrelated business taxable income” (UBTI) once it leaves a trust or estate and passes out to a tax-exempt entity subject to UBTI?

**NO**.

The above code and regulations are irrelevant to this issue. Unlike qualified dividends, interest or short/long term capital gain, which would remain and be taxed as such in the hands of the beneficiary in the same manner as if it were trapped in the trust (albeit with different brackets, exemptions, etc.), any such business income would **not** be UBTI in the hands of the trust or estate. There is never any UBTI in the trust or estate to ever start out and “remain” as such in the hands of a tax-exempt beneficiary. UBTI is a completely separate section of the tax code (IRC §§511-515).

IRS Publication 598 “Tax on Unrelated Business Income of Exempt Organizations” has no mention of UBTI being received from an estate or trust, it only mentions receiving UBTI from an S corporation or partnership owned directly by the tax exempt organization.

IRC §512 and §513 outline what is and is not UBTI.[[509]](#footnote-510) Congress felt obliged to add specific provisions to make K-1 income from S corporations and partnerships owned by a charitable entity UBTI, despite the fact that such pass through entities pass through the *character* of their income as well.[[510]](#footnote-511) The reason for this is that UBTI is not a “character”, it’s a separate tax scheme applicable to certain charitable entities that own and derive income “from any unrelated trade or business regularly carried on by it”. There is an attribution scheme for S corporations and partnerships owned by trusts, but no such scheme to attribute income from ordinary trusts and estates, except for the narrow purpose of application of §681, which would clearly not apply to distributions to CRTs (nor probably to other tax-exempt but non-charitable entities).

IRS Form K-1 instructions for partnerships have specific instructions to partnerships for calculating UBTI for tax-exempt partners, but Form K-1 instructions for estates/trusts *lack any mention or instruction on the matter whatsoever*.[[511]](#footnote-512) Instructions for S corporation K-1s lack instructions, but that’s completely understandable since *all* S corporation income is UBTI and any parsing or reporting as UBTI would be unneeded.

A distribution from an estate or trust to a Charitable Remainder Trust is not eligible for the income tax charitable deduction; it is deductible, if at all, only as an income distribution deduction, up to distributable net income (DNI).[[512]](#footnote-513)

A distribution to a charitable remainder trust is eligible for the DNI deduction, to the extent it meets the other requirements of that deduction. Treas. Reg. § 1.664-1(a)(5)(iii) provides:

“The treatment of a distribution to a charitable remainder trust, or to a recipient in respect of an annuity or unitrust amount, paid, credited, or required to be distributed by an estate, or by a trust which is not a charitable remainder trust, shall be governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.”

Treas. Reg. §1.664-1(a)(6), Example 5 provides:

“In 1973, H dies testate leaving the net residue of his estate (after payment by the estate of all debts and administration expenses) to a trust which meets the definition of a charitable remainder unitrust. For purposes of section 2055, the trust is deemed created at H's death if the requirement to pay the unitrust amount begins on H's death and is a charitable remainder trust even though the estate is obligated to pay debts and administration expenses.

For purposes of section 664, the trust becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless the trust has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of the Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. ***Any distributions made by H's estate, including distributions to a recipient in respect of unitrust amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664***.”

In other words, distributions to CRTs are treated no differently from distributions to other non-charitable beneficiaries. To the extent of the DNI ceiling, distributions carry out income and the CRT would receive a K-1, no different than if the CRT had received a Form 1099-R distribution from a traditional IRA or 401(k).

**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 basis techniques discussed in Part III won’t help a wealthy couple with $100 million a bit, but they can be extremely valuable for sub-$10.9 million estates. The basis increasing techniques in Part V may apply to middle class and wealthy alike.

The *ongoing* trust income tax planning techniques discussed in Part VIII apply to all estate levels – *even more so* for 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?[[513]](#footnote-514) Even those rare wealthy families whose children/grandchildren/great-grandchildren all make over $450,000/year 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 $10.9 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 $5.45 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 § 678(a) variant discussed in Part VIII may even alleviate some of the accounting/tax filing 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 (potentially for fractional interests held w/survivor outright as well as trust), better compatibility with disclaimer planning at first death, enabling disclaimer planning at second death, better ongoing income tax treatment for the trust and spouse overall and better income tax flexibility and charitable deduction treatment via spray provisions or lifetime limited powers of appointment.

The Optimal Basis and Income Tax Efficiency Trust offers the following advantages over a traditional QTIP (assuming estates 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 (though in some instances, QTIPs are *more* GST efficient), less complicated administration/compliance for retirement plan/IRA benefits,[[514]](#footnote-515) 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 spray or shift income with better charitable deductions up to 100% of trust AGI with no Pease limitations and a one-year lookback, ability to gift or transact with the trust without the IRC §2519 gift tax trap, ability to shelter from 16%-20% state estate/inheritance tax, ability to better avoid inadvertent unwanted discounting for fractional interests owned w/spouse, no requirement to file (or chance to botch) Form 706 to make appropriate QTIP election, no prospect of Congress eliminating the estate tax and marital deduction altogether and thus the second step up in basis, better ability to decant/amend, ability to add “poison pill”/cessor language for Medicaid/tax lien/asset protection, ability to do disclaimer planning nine months from the surviving spouse’s death to the extent of any general testamentary power and of course the prevention of a second step *down* in basis for assets in trust with basis higher than FMV.

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.[[515]](#footnote-516) Realize that any higher inflation over a longer period of time exacerbates this effect extensively, since the locked in DSEU amount does ***not*** adjust for inflation. And remember, the first to die’s family usually gets stuck with the tax apportionment – important for blended families and important even for residents with smaller estates who live in states with a separate estate tax.[[516]](#footnote-517)

There are some narrow situations in which a marital trust will generate better estate tax results than an OBIT.[[517]](#footnote-518) 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, none go down in value, 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, future 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 exact 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* and even these benefits are typically delayed until sale. This is probably *not nearly as important* *to the surviving spouse* as the *ongoing income tax efficiency* of the trust. The ability to spray income to beneficiaries in lower brackets and obtain better charitable deductions and asset protection can be much more important because the spouse benefits *while still alive*.

This improved flexibility includes post-mortem amendments. An OBIT can often be amended in various ways to adapt to change in circumstance or tax law, via trust protector, decanting or otherwise.[[518]](#footnote-519) By contrast, a marital trust must not only avoid any substantial amendments, but must curb any *potential* for amendments (beyond what is permitted under state law), else the marital deduction will be denied (and hence, the subsequent step up in basis).[[519]](#footnote-520)

Using the Delaware Tax Trap to maximize basis in some circumstances may be 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, unlike *general* powers which have ample precedent and guidance, there is only one reported case construing the Delaware Tax Trap. Ideally, we’d trigger the Delaware Tax Trap by creating successive *limited* powers of appointment, but as of late 2016 only two states clearly permit this.

There will certainly be certain assets or situations in which these techniques should not be used. Qualified retirement plan/IRA assets receive longer tax deferral if left outright to a spouse, for example, so absent blended family situations, using outright dispositions with portability for such assets is often the best plan. Similarly, large deferred compensation payouts or other income in respect of a decedent may be more optimized going outright or to a charitable remainder trust. We can certainly think of others, but the Optimal Basis Increase and Income Tax Efficiency Trust should probably be the new default plan for most married couples, absent some of the more exceptional situations noted above – it offers all of the benefits of the traditional bypass trust and more, with avoidance of most of the drawbacks. See the comparison charts in the appendix for a broad overview of factors.

Many taxpayers have been reticent to pay for needed amendments to planning due to “tax volatility fatigue” and frustration with Congress. The pitfalls of the status quo and the improved tax techniques discussed in this article should give these taxpayers substantial financial incentives 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 for clients.

**Speaker Bio**

Edwin P. Morrow III

[edwinmorrow@msn.com](mailto:edwinmorrow@msn.com)

Ed is currently a Wealth Strategist for Huntington National Bank, where he concentrates on thought leadership and planning ideas for high net worth clientele in tax, asset protection and estate planning areas. Previously, he was in similar positions with U.S. Bank's Private Wealth Management and Key Private Bank's Family Wealth Advisory Group, analyzing tax, trust and estate planning needs of ultra high net worth clients in conjunction with local teams of financial planners, trust officers, investment specialists and private bankers.

Previous to working in wealth management, Ed was in private law practice concentrating in taxation, probate, estate and business planning. Other experience includes research and writing of legal memoranda for the U.S. District Court of Portland, Oregon as a law clerk. He is a Fellow of the American College of Trust and Estate Counsel (ACTEC). He is a Board-Certified Specialist (through the Ohio State Bar Assn) in Estate Planning, Trust and Probate Law, a Certified Financial Planner (CFP) professional and a Certified Merger & Acquisition Advisor (CM&AA). He is also a Non-Public Arbitrator for the Financial Industry Regulatory Authority (FINRA).

Ed is a frequent speaker at CLE/CPE courses on asset protection, tax and financial and estate planning topics, and recently co-authored, with Stephan Leimberg, Paul Hood, Martin Shenkman and Jay Katz, the 18th and now 19th Edition of The Tools and Techniques of Estate Planning, a 997-page practice-based resource on estate planning.

He is married and resides in Centerville, Ohio with his wife and two daughters.

**Education:**

* Bachelor of Arts (B.A.), History, Stetson University
* Juris Doctorate (J.D.), Northwestern School of Law at Lewis & Clark College
* Masters of Law (LL.M.) in Tax Law, Capital University Law School
* Masters of Business Administration (MBA), Xavier University

**Professional Accreditations:**

* Licensed to practice in all Ohio courts, U.S. District Court of Southern Ohio and U.S. Tax Court
* Certified Specialist through Ohio State Bar Assn in Estate Planning, Trust and Probate Law
* Certified Financial Planner (CFP®)
* Certified Merger and Acquisition Advisor (CM&AA®)
* Non-Public Arbitrator for the Financial Industry Regulatory Authority (FINRA)

**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](http://www.law.cornell.edu/uscode/text/26/2035) to [2038](http://www.law.cornell.edu/uscode/text/26/2038), 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***](http://www.law.cornell.edu/uscode/text/26/2035)***,*** [***2036***](http://www.law.cornell.edu/uscode/text/26/2036)***, or*** [***2037***](http://www.law.cornell.edu/uscode/text/26/2037)***,***

***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.

**26 U.S.C. §1014 (bold, italics and [brackets] added by author)**

**(a)In general** Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent’s death by such person, be—

**(1)** the fair market value of the property at the date of the decedent’s death,

**(2)** in the case of an election under section 2032, its value at the applicable valuation date prescribed by such section,

**(3)** in the case of an election under section 2032A, its value determined under such section, or

**(4)** to the extent of the applicability of the exclusion described in section 2031(c), the basis in the hands of the decedent. [this is the additional exclusion provision for qualified conservation easements]

**(b)Property acquired from the decedent** For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent: [NOTE: if the estate tax is repealed – paragraphs 6, 9, 10 require *inclusion]*

**(1)** Property acquired by bequest, devise, or inheritance, or by the decedent’s estate from the decedent;

**(2)** Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;

**(3)** In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;

**(4)** Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;

**(5)** In the case of decedents dying after August 26, 1937, and before January 1, 2005, property acquired by bequest, devise, or inheritance or by the decedent’s estate from the decedent, if the property consists of stock or securities of a foreign corporation, which with respect to its taxable year next preceding the date of the decedent’s death was, under the law applicable to such year, a foreign personal holding company. In such case, the basis shall be the fair market value of such property at the date of the decedent’s death or the basis in the hands of the decedent, whichever is lower;

**(6)**

In the case of decedents dying after December 31, 1947, property which represents the surviving spouse’s one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent’s gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;

**[(7)**, (8) Repealed. [Pub. L. 113–295, div. A, title II, § 221(a)(74)](http://www.gpo.gov/fdsys/pkg/PLAW-113publ295/html/PLAW-113publ295.htm), Dec. 19, 2014, [128 Stat. 4049](http://uscode.house.gov/statviewer.htm?volume=128&page=4049)]

**(9)**In the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent’s gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939. In such case, if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent. Such basis shall be applicable to the property commencing on the death of the decedent. This paragraph shall not apply to—

**(A)** annuities described in section 72;

**(B)** property to which paragraph (5) would apply if the property had been acquired by bequest; and

**(C)** property described in any other paragraph of this subsection.

**(10)** Property includible in the gross estate of the decedent under section 2044 (relating to certain property for which marital deduction was previously allowed). In any such case, the last 3 sentences of paragraph (9) shall apply as if such property were described in the first sentence of paragraph (9).

**(c)Property representing income in respect of a decedent**

This section shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

**(d)Special rule with respect to DISC stock**

If stock owned by a decedent in a DISC or former DISC (as defined in section 992(a)) acquires a new basis under subsection (a), such basis (determined before the application of this subsection) shall be reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date. In computing the gain the decedent would have had if he had lived and sold the stock, his basis shall be determined without regard to the last sentence of section 996(e)(2) (relating to reductions of basis of DISC stock). For purposes of this subsection, the estate tax valuation date is the date of the decedent’s death or, in the case of an election under section 2032, the applicable valuation date prescribed by that section.

**(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***.

**(f) Basis must be consistent with estate tax return** For purposes of this section—

**(1) In general** The basis of any property to which subsection (a) applies shall not exceed—

**(A)** in the case of property the final value of which has been determined for purposes of the tax imposed by chapter 11 on the estate of such decedent, such value, and

**(B)** in the case of property not described in subparagraph (A) and with respect to which a statement has been furnished under section 6035(a) identifying the value of such property, such value. ***[this refers to the new beloved Form 8971]***

**(2) Exception**

Paragraph (1) shall only apply to any property whose inclusion in the decedent’s estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate.

**(3) Determination** For purposes of paragraph (1), the basis of property has been determined for purposes of the tax imposed by chapter 11 if—

**(A)** the value of such property is shown on a return under section 6018 and such value is not contested by the Secretary before the expiration of the time for assessing a tax under chapter 11,

**(B)** in a case not described in subparagraph (A), the value is specified by the Secretary and such value is not timely contested by the executor of the estate, or

**(C)** the value is determined by a court or pursuant to a settlement agreement with the Secretary.

**(4) Regulations**

The Secretary may by regulations provide exceptions to the application of this subsection.

**Treasury Regulation § 1.1014-1 Basis of property acquired from a decedent.**

**(a)** ***General rule.***The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death, or, if the decedent's executor so elects, at the alternate valuation date prescribed in section 2032, or in section 811(j) of the Internal Revenue Code of 1939. Property acquired from a decedent includes, principally, property acquired by bequest, devise, or inheritance, and, in the case of decedents dying after December 31, 1953, property required to be included in determining the value of the decedent's gross estate under any provision of the Internal Revenue Code of 1954 or the Internal Revenue Code of 1939. The general rule governing basis of property acquired from a decedent, as well as other rules prescribed elsewhere in this section, shall have no application if the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent. For general rules on the applicable valuation date where the executor of a decedent's estate elects under section 2032, or under section 811(j) of the Internal Revenue Code of 1939, to value the decedent's gross estate at the alternate valuation date prescribed in such sections, see paragraph (e) of §[1.1014-3](https://www.law.cornell.edu/cfr/text/26/1.1014-3).

**(b)** ***Scope and application.***With certain limitations, the general rule described in paragraph (a) of this section is applicable to the classes of property described in paragraphs (a) and (b) of § 1.1014-2, including stock in a DISC or former DISC. In the case of stock in a DISC or former DISC, the provisions of this section and §§1.1014-2 through 1.1014-8 are applicable, except as provided in § [1.1014-9](https://www.law.cornell.edu/cfr/text/26/1.1014-9). Special basis rules with respect to the basis of certain other property acquired from a decedent are set forth in paragraph (c) of § [1.1014-2](https://www.law.cornell.edu/cfr/text/26/1.1014-2). These special rules concern certain stock or securities of a foreign personal holding company and the surviving spouse's one-half share of community property held with a decedent dying after October 21, 1942, and on or before December 31, 1947. In this section and §§ 1.1014-2 to 1.1014-6, inclusive, whenever the words *property acquired from a decedent* are used, they shall also mean *property passed from a decedent,* and the phrase *person who acquired it from the decedent* shall include the *person to whom it passed from the decedent.*

**(c)** ***Property to which section 1014 does not apply.***Section 1014 shall have no application to the following classes of property:

**(1)** Property which constitutes a right to receive an item of income in respect of a decedent under section 691; and

**(2)** Restricted stock options described in section 421 which the employee has not exercised at death if the employee died before January 1, 1957. In the case of employees dying after December 31, 1956, see paragraph (d)(4) of § [1.421-5](https://www.law.cornell.edu/cfr/text/26/1.421-5). In the case of employees dying in a taxable year ending after December 31, 1963, see paragraph (c)(4) of § [1.421-8](https://www.law.cornell.edu/cfr/text/26/1.421-8) with respect to an option described in part II of subchapter D.

**§ 1.1014-3 Other basis rules.**

(a) Fair market value. For purposes of this section and § 1.1014-1, the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its fair market value. If no estate tax return is required to be filed under section 6018 (or under section 821 or 864 of the Internal Revenue Code of 1939), the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable.

**Glossary of Terms[[520]](#footnote-521)**

**“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, (aka Non-general) Power of Appointment” (“LPOA”) –** any power that is not a general power of appointment. Some also use the term “special power of appointment”, a narrower subset of LPOAs – 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.

**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*

“It is not the critic who counts; not the man who points out how the strong man stumbles, or where the doer of deeds could have done them better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood; who strives valiantly; who errs, who comes short again and again, because there is no effort without error and shortcoming; but who does actually strive to do the deeds; who knows great enthusiasms, the great devotions; who spends himself in a worthy cause; who at the best knows in the end the triumph of high achievement, and who at the worst, if he fails, at least fails while daring greatly, so that his place shall never be with those cold and timid souls who neither know victory nor defeat.” ― **Theodore Roosevelt** **Page**

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27) Comparison Chart - Various Basic Trust Design Options for Married Couples

Note: Above sample clauses are not in the publicly available version of this outline, see [www.ultimateestateplanner.com](http://www.ultimateestateplanner.com) for these, with updates and additional material.

**[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 a new wife/husband or others “undesirable” to the settlor as potential beneficiary – if a power holder can appoint to a power holder or a power holder’s estate, this is construed to include ANYONE, including new spouse, charity, etc, whereas if a power holder can appoint to creditors only, the permissible appointees are only bona fide creditors][[521]](#footnote-522) 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 \_\_\_\_\_\_\_\_\_\_\_ 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 (or should one or more predecease the power holder to that child’s issue or trusts therefore per stirpes), may only be made with the consent of \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ or alternatively, with the unanimous consent of my children. Should one or more of my children predecease the power holder leaving issue, consent may be obtained from their issue per stirpes, which may be obtained by virtual representation pursuant to Ohio R.C. §5803.01 et seq (Uniform Trust Code §§301-305)”.[[522]](#footnote-523)

[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**:

* 1. 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;
  2. Roth IRA accounts or Roth variants of other retirement plans such as 403(b), 457(b), or 401(k) plan accounts;
  3. 529 Plan Accounts or Coverdell Education Savings Accounts (ESAs);
  4. 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;
  5. all life insurance policy or annuity death benefit proceeds owned by and payable to the trust as a result of my spouse’s death.

[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 my preferred variation:

[Alternate #2 preferred 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 without triggering income tax if included in the powerholder’s estate. [note, the phrase “without triggering income tax” was added to this language in 2015 as a result of the Obama Administration Greenbook proposals to use “mark to market” income tax scheme, triggering capital gains on the fair market value of assets minus basis at the death of the owner. See http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf, pages 156-157. While it’s unlikely to pass, it cannot hurt to add this language. New post-election note: President Trump proposed a similar scheme on his website, in lieu of an estate tax, but never tried to introduce any such legislation. Several proposals have resurfaced under the Biden administration, so it’s still possible that the “step up” in basis may be limited in the future at some point. If there is ever a cap on the mark-to-market scheme, such as excluding home or $2 million of gain, etc., this can probably best be addressed via the amendment power, but I add such clauses to cover cases where, pursuant to Murphy’s law, someone dies before being able to amend the provision]

[Alternate cap #1 with 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, **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 cap #2 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]

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 such that the total appointive assets do not rise to a level to generate any federal or state estate or generation skipping transfer tax liability.

[Alternate to modify either of the above to cause a minimal amount of estate tax – add “of more than $10”. Why do this? To enable an alternate valuation date, which in some rare instances may yield superior basis results. You can only elect alternate valuation date (AVD) as long as your estate tax is reduced. E.g. I die single with $5 million estate, $5.43 million AEA. I have a trust from my sister over which I have a formula GPOA with $1 million of appreciated assets - the appointive assets subject to the GPA is by formula limited to $430,000 (or slightly more, if there are debts, expenses, potentially charitable bequests depending on how it’s written). 6 months later, the markets take a dip – now my estate is $4 million, the trust $800,000. My estate cannot elect AVD with the above formulas because it would not reduce the estate tax. However, usually I would not want to – in my example, the basis would be reduced to $4 million and $800,000, rather than $5 million and something shy of $1 million. In most cases, it would be a losing proposition. However, there could be rare cases where you would want to, depending on the basis and make up and correlation in return between the pools of assets, and how the change in value between the pools post-mortem may differ. For instance, if I have a $5 million IRA that reduces to $4 million by the AVD, I could care less about reduction in that basis – in that scenario I would want a taxable estate, and to elect AVD to save a dollar of tax, because now my GPA is soaking up $800,000 new basis, not just $450,000. That all gets fairly complicated to predict, of course. However, a formula that caps at $10 rather than $0 of tax has very little risk, and potential for significant upside in some situations].

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 at date of death of $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 the partnership has yet made an election under IRC §754. [Note, you might even choose to carve out publicly traded partnerships or other partnerships in which it is known that a Section 754 election will not be made, but again, trying to eke out every last optimal advantage yields less and less benefit, so most would value simplicity. Similarly, S corporations may benefit from outside basis increase, but in most cases less than LLC/LPs taxed as partnerships because the inside basis cannot be stepped up – the difference largely depends on whether the property would be sold immediately – selling the S corporation stock may unlock the additional outside basis].

[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 in some narrow cases, 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% Section 1250 recapture rate + 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, thepower shall apply to the building first, then the artwork, then the stock.]

[note: my own preference would be to use a simple artificial grossing up of the difference for depreciable property (less so collectibles), because unlike other assets, added basis to depreciable property benefits taxpayers whether the property is sold or not (unless, for instance, it is a personal use vacation home etc. in hands of heirs that would not be depreciable.]

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][alternative, “to greater than $10”], 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 [section XX.X] 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 or any successor tax provision of the property held in the Family Trust without increasing my spouse’s federal or state estate or generation skipping transfer tax [to greater than $10], without triggering any substantial income tax realization event (if current law should change, and without subjecting substantial trust assets to my spouse’s creditors should my spouse’s estate be insolvent, so as to provide the maximum 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, §2041 or other applicable tax law be materially changed, such as 2016 fiscal year Obama Administration Greenbook proposals;

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

c) my spouse remarry and reside in a jurisdiction with a spousal elective share definition that would otherwise include appointive assets subject to a third party created testamentary general power of appointment, without having a valid pre or post nuptial agreement that would otherwise exclude these trust assets

c) my spouse’s projected 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.[[523]](#footnote-524)

1. **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 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.
2. **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 (i.e. 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”][[524]](#footnote-525). Should multiple attempts to exercise conflict, the last executed document shall control. The trustee may in good faith 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.[[525]](#footnote-526)

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 some states, but not all, a POA that can dateriStatutes 45a-572. But your law may be contrary – see Restat, 3d, Prop., Donative Transfers, §19.14, cmt g, UPOAA §305(c), so unless you know for certain your client’s residency and state law on this issue, it safest to expressly permit it. See also 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 does not authorize an appointment to the children for life, with the remainder to their children**.”[[526]](#footnote-527)

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. If one of the trusts is GST-exempt and one of the trusts is not, the general power shall first apply to so much of the assets of the GST non-exempt trusts that will not cause an estate tax in the powerholder’s estate of more than $10, and then to the GST exempt trust.

**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 or statements 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 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 six 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.

**Note#5** (FAQ) – Common questions at CLEs: Does exercising a POA via Will require probate of the will, or if exercised, subject it to probate? A: No. A POA can be validly exercised without a Will being admitted to probate, unless the Will specifically requires, but a purported Will **rejected** by the Probate Court as invalid will **not** validly exercise a POA.[[527]](#footnote-528) Exercise of a POA by Will does **not** subject appointive assets to probate.

**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.**

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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.

2) **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.

**[two formula GPOA clauses designed to minimize GST tax, first is a simpler safer version, second is a more complex version that might be more tax efficient]**

1. **Testamentary Power of Appointment**. Upon the death of [the Primary Beneficiary or however this person is defined in the trust], the trustee shall distribute the remaining assets as the beneficiary appoints between the following two classes of potential appointees, described as follows:

(a)        General Power: The powerholder may appoint to all persons, including the [powerholder’s estate or] creditors of the powerholder’s estate, with respect to that portion of the trust assets that would be subject to generation skipping transfer (GST) tax under Chapter 13 of the Code (IRC Section 2601 et seq), but for the general power granted under this subsection (a) and without regard to any exercise of the limited power described in subsection (b).

(b)       Limited Power: To the extent the general power in subsection (a) does not apply, then the powerholder may appoint to all persons, specifically excluding, however, the beneficiary, the beneficiary’s estate, the beneficiary’s creditors, and the creditors of the beneficiary’s estate.

[note: of course, in some situations the settlor may want to curb the general or limited power even further, or not grant a limited power at all. This power is considered more conservative, because it does not in any way rely on the available applicable exclusion amount or value of the *powerholder’s* estate. This is somewhat similar, in fact, to dividing a trust between GST exempt and GST non-Exempt trusts and granting a limited power in the former and general power in the latter. Even if one does this, however, a formula general power like the above can help in situations where the trust is not divided, or the GST tax is repealed, or other situations. As with all the other clauses noted herein, an independent trustee or trust protector power to amend might come in handy to adapt to future tax law changes.

As discussed previously, the ability to appoint to “creditors” should be deemed to be a general power regardless of one’s debts, but there are some that prefer a more conservative approach noted in brackets above that also enables appointment to one’s estate. Some may wish to clarify that *persons* includes trusts therefore if the term is not defined elsewhere in the document, but under common law the default is that appointments may be made in further trust. As discussed in the white paper, sometimes people will include a savings clause to prevent the exercise of a limited power that would inadvertently trigger the Delaware Tax Trap (IRC 2041(a)(3), but see the paper for suggestions to modify such clauses to prevent them from being overbroad. This paragraph does not define whether the power is exercised via Will or whether a living trust or other document is sufficient.]

**2. Testamentary General Power of Appointment**. If upon the death of a Power Holder, all or any part of the assets of the Power Holder's subtrust would, but for the grant of a testamentary general power of appointment to the Power Holder under this paragraph, pass in a manner that would cause such property to be subject to the federal generation skipping transfer ("GST") tax under Chapter 13 of the Code (IRC Section 2601 et seq) , then the Power Holder shall have the power by his or her last will and testament, making express reference to this power, to appoint outright or in trust to whomever or whatever entities the Power Holder chooses (including the Power Holder's estate, the Power Holder's creditors or the creditors of the Power Holder's estate) an amount of property (the "Power Holder's GPA amount'') determined as follows.

The Power Holder's GPA amount shall be that amount of property in the Power Holder's subtrust, if any, that, when included in the Power Holder's gross estate by virtue of this power, will result in the maximum reduction in the sum of the federal and state GST, estate, legacy, succession, inheritance and similar taxes imposed by reason of such Power Holder's death with respect to the property in the Power Holder's subtrust, when compared to the sum of such taxes that would be imposed by reason of the Power Holder's death with respect to the property in the Power Holder's subtrust if no testamentary general power of appointment were conferred on the Power Holder under this Section. Should the law hereinafter be amended so that death is also an income tax realization event, then the potential income tax ramifications of granting or not granting such a power shall also be considered.

To the extent that the trustee is delayed in determining the ultimate appointees under this power, the trustee and any potential appointees or takers in default may enter into an indemnification or administration agreement regarding the ramifications of any later change in the appointed amount.

[note: unlike the first version, this one does not contain a limited power over all assets not subject to the general power, but that would usually be preferred.

This one is more unique in that it attempts to minimize the tax rather than use a blunt hammer. But, it is more complicated! If the IRS reduces the GST tax rate to 35% and increases the estate tax rate to 45%, or vice versa, this formula adapts, but the prior formula would not.

Whenever there is a contingency based on a powerholder’s estate size and taxable situation, this has the ability to delay the administration of the trust. Often it would not affect most ongoing administration, because the powerholder is probably never going to exercise his or her limited or general power differently – usually they appoint to children, spouse, trusts therefore, or not at all, and the trust can be administered the same no matter what portion is limited and what portion is general – the only difference will be determination of taxes and determining the cost basis of the assets.]

1. **More Sample Language (Simplified versions of formula GPOAs, no ordering rules)**

**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.

**Basic Formula General Power of Appointment copied from PLR 2004-03094:**

At my wife’s death, if I am still living, I give to my wife a testamentary general power of appointment, exercisable alone and in all events to appoint part of the assets of the Trust Estate, having a value equal to (i) the amount of my wife’s remaining applicable exclusion amount less (ii) the value of my wife’s taxable estate determined by excluding the amount

of those assets subject to this power, free of trust to my deceased wife’s estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my wife may direct in her Will. **Additional Language to Cap a testamentary GPOA in the event a Power Holder’s Estate is Substantially Insolvent (to prevent appointive assets from potentially being diverted to a power holder’s estate’s creditors) – based on PLR 9110054, discussed in Part III.m.**

**“Additional prerequisite for and restrictions on a power holder’s GPOA**

In the event that the enforceable liabilities of the beneficiary power holder's estate exceed the value of the assets against which the estate’s creditors could otherwise enforce against (based upon values as finally determined in the federal or state estate tax proceedings of the beneficiary's estate, excluding the Power) by more than $5,000 [or pick another de minimis amount], no testamentary General Power of Appointment is granted herein unless the (i) the amount of tax basis that would be increased by reason of the beneficiary's death computed as if the property that would be appointable by this power if not for this paragraph had been included in the beneficiary's gross estate, (ii) times 20% (this could be less of course, or perhaps you use a higher number in a high tax state, or estate with depreciable property/collectibles) exceeds the excess of the enforceable liabilities of the beneficiary's estate over its assets, computed as if there were no General Power granted.

By way of example in explaining this paragraph, if the amount of tax basis that would otherwise be gained by the above mentioned testamentary formula GPOA without the above paragraph would be $600,000, and the power holder’s estate is insolvent with a deficit of $100,000, the formula power of appointment would still be granted, because $600,000 times 20% = $120,000, which exceeds $100,000.”

Note: taxable estate assets pulled in under 2035 or 2036 may not be subject to creditors under state law as GPOA appointive assets might, and life insurance may also be included in a taxable estate but have similar creditor protection, hence the reference above to assets to which a creditor might otherwise enforce against. Few estates of families with enough wealth to use trusts are completely and substantially insolvent and have aggressive creditors coming after their estate within the statute of limitations, and aggressive enough to go after non-probate assets that would be more difficult to reach in the best of circumstances. But, it can’t hurt to add this in my opinion.

Note to self: Also research whether, if someone has an LPOA and a GPOA, can they exercise the LPOA, or is that deemed to exercise the GPOA? What if we make potential appointees DIFFERENT BENEFICIARIES? That may avoid the problem of the *inadvertently exercised* GPOA.

**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:

I hereby appoint the following assets to the:

1. [newly drafted Trust for a child or other intended beneficiary that grants the beneficiary a PEG Power – presently exercisable general power of appointment] or,
2. [the XYZ Appointive Trust], which shall be identical to the subtrust under Article III, Paragraph A of the XYZ Trust dated XX/XX/XXXX, which terms are incorporated herein, with the exception that this trust shall have the following additional paragraph applied: “During my child’s [beneficiary’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 [beneficiary] 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] [or simply don’t appoint the other assets at all and let them pass via residuary]

**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.

**A Simple Idea: Tax Shifting of Inherited Retirement Plan Distributions**

**Sample language for a lifetime limited power of appointment in a Bypass (Family) Trust or a Standalone IRA Trust or other Trust or Subtrust designed and intended to be a designated beneficiary “see through trust” - enabling the surviving spouse (or another party if this is a collateral power, or successor beneficiaries) to shift ordinary income tax from inherited IRA distributions to lower generations in lower tax brackets (including state income tax)**

37% (likely trust rate TI >$12,500) 🡪 15% (bene)

If $100,000 RMD is shifted, likely savings $22,000/yr!

Substantial annual savings.

(Remember, a lifetime limited power of appointment will prevent a spousal conduit trust from being a “sole beneficiary”. Spousal conduit trusts have two significant income tax advantages over spousal accumulation trusts, notably, a delayed required beginning date if the decedent spouse is under age 70 ½, and a more favorable calculation method of recalculating the life expectancy under the single life tables every year – see separate CLE material by author on that topic. However, several factors indicate adding a spousal lifetime limited power of appointment to enable shifting taxation of retirement plan distributions:

1. The IRA/QRP would be payable to a bypass/credit shelter trust, rather than a QTIP trust. A QTIP trust cannot have a lifetime limited power of appointment.

and;

1. The settlor/decedent spouse is close to or over 70 ½ (thus negating the more powerful of the two tax advantages to sole beneficiary spousal conduit trusts); or
2. The spouse might be inclined to make gifts and is in a higher tax bracket than children (and may like to shift income taxation); or
3. The plan is to use an accumulation trust. For many attorneys, these are preferred regardless, for asset protection or estate tax leveraging or maximizing bloodline/divorce protection etc. If the plan is to forego the minor conduit trust advantage to use an accumulation trust, there is zero downside to adding a lifetime limited power of appointment, absent a settlor’s worry it would be improvidently used – and this worry could be assuaged by adding another party’s required consent.

So, accumulation trusts should usually have such clauses, and there are many situations (e.g. older settlors) where the minor advantage of a spousal sole beneficiary conduit trust should be relinquished in favor of the various asset protection and tax shifting advantages of an accumulation trust. Such clauses should be much more commonly used, if not always, in trusts for non-spouses [the second paragraph].

[Power for Spouse] During my spouse’s lifetime, my spouse shall have the non-fiduciary limited power to appoint, from income or principal, in cash or in kind, all assets of this trust to any or all of my descendants.

[Power for Children or other Non-Spouses beneficiaries\*\*\*There is virtually NO drawback to including such a provision, and tremendous asset protection and tax shifting upside] During my child’s lifetime, my child shall have the non- fiduciary limited power to appoint, from income or principal, in cash or in kind, all assets [some settlors might limit the amount of assets appointable to gross taxable income annually or to some other % annually to prevent a soft touch child from depleting their inherited assets too quickly] of this trust to any or all of my descendants (excluding the power holder), potentially to the exclusion of others.

However, for any qualified retirement plan, IRA or similar accounts (other than a plan inherited by me prior to my death and not rolled over from my spouse into my name as owner), and for any assets traceable to distributions from such accounts described above, such appointment may only be made to individuals younger than the power holder, outright. This power shall NOT include the power to appoint such assets to trusts, even if state law would otherwise permit such an appointment.

In addition, such lifetime power shall not apply to any S corporation stock or income or distributions therefrom over which a Qualified Subchapter S Trust (QSST) election has been made. This limited power of appointment shall not be exercisable, directly or indirectly, to discharge any legal obligation of the powerholder.

The above limited lifetime power of appointment is intended to be retained while still qualifying any qualified retirement plans or IRAs made payable to this trust as a designated beneficiary pursuant to Treasury Regulation §1.401(a)(9)-5, A7, and enabling qualification of this trust as an eligible owner of Subchapter S stock in the event a qualified subchapter S trust election is made by the beneficiary. 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, full 2036 inclusion, full step down at second death and depending on the state potentially loss of asset protection). 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 regulations 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:

* 1. 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
  2. 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, for the entire amount distributed, 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 (QTIP) 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 280.

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**

**(a.k.a., collateral power)**

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. The power holder may not appoint trust property in any manner that would discharge his or her obligation to support any appointee.

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” intended to qualify as designated beneficiaries per Treas. Reg. 1.401(a)(9)-5 and trusts over which beneficiaries make qualified subchapter S trusts (QSSTs) per §1361 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 Provisions to Enable and Order Distributions of Capital Gains to be Carried Out to Beneficiaries**

**Trust Accounting for Discretionary Distributions to Beneficiaries**

"To the extent that discretionary distributions are made from capital gains allocated to 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 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);

1. from any remaining net short term capital gains not described in the above paragraph;
2. from any 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);

4) lastly, from any remaining current year long-term capital gains not described in the above paragraph.

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

Alternate

“In exercising the trustee’s discretion to distribute principal, my trustee shall consider any capital gains realized by the trust as an important and relevant, but not the sole or determinate, factor in determining the amount that is to be distributed pursuant to its discretion. This sentence is intended to ensure the trustee consider this as an important issue in determining the amount of distributions and to comply with Treas. Reg. §1.643(a)-3(b)(3) to enable maximum discretion for not only distributions, but the tax effect of any distributions and whether they carry out capital gains as part of DNI. “**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

* + - * 1. specifically refers to this paragraph, or
        2. specifically asserts an intention to trigger Section 2041(a)(3) or Section 2514(e) of the Internal Revenue Code of 1986, or
        3. 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).

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.]

[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**

**(some states require, and for others notice may be suggested anyway under duty to inform)**

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, state and federal tax law 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 –**

**Ohio R.C. §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].”

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].

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.

[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:

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

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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.[[528]](#footnote-529)
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, as trusts often have a savings clause preventing this result, and many states have savings statutes.
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 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.[[529]](#footnote-530)
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.

**Forfeiture provision to add to spendthrift clause for better asset protection, with an appropriate carve out for marital deduction trusts, QSST, IRA, §678(a)**

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 distribution provisions (including a terminating distribution, unless required by the applicable rule against perpetuities) 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 any of 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 against a spouse, 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.

Also – if you have trustee/beneficiary, “interested trustee” clauses, they might be integrated with this section to remove HEMS standards and require independent trustee to be appointed.

The death of a beneficiary shall also constitute a complete termination of such beneficiary’s interest in the trust and any payments accrued or undistributed by the trustee at the time of death of such beneficiary shall be distributed to the succeeding beneficiaries otherwise entitled to distributions from the trust. 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 be presumed to indicate an intent not to qualify for the marital deduction.

[In addition, the effect of the above provisions shall be delayed in removing a beneficiary’s sole power to withdraw current year income pursuant to Paragraph XXX [cite BDOT provision]. In such case, the above provisions shall only apply prospectively to future income (or if it is anticipated that a BDOT may engage in an installment sale with its deemed owner, it may be best for the forfeiture clause to apply as of January 1 of the following year, to give some time to unwind any such transaction).]

The above provisions shall expressly apply to powers of revocation, rights to corpus, powers of 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 state that the entire clause does not apply to a marital trust or QSST or conduit trust. DON’T DO THAT. Treasury Regulations specifically authorize a basic spendthrift clause preventing assignment, alienation, etc, just not one that goes further to cause an actual forfeiture of the mandatory income interest.

**Alternative disposition to save exclusion if DSEU/706 filing is botched**

(see Part II, page 10, footnote 22)

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, or a pecuniary marital, residual bypass would be desirable if IRD such as large deferred compensation plans might be involved].

**Formula GPOA for GST non-exempt trust to optimize between GST and Estate Tax Efficiency**

Contingent Testamentary General Power of Appointment. If upon the death of a beneficiary of this trust a taxable termination would occur (either directly, or indirectly by the beneficiary's failure to exercise a power of appointment), then the beneficiary shall have the testamentary general power to appoint to the creditors of the beneficiary's estate the smallest fractional share of the trust property that would reduce to a minimum the aggregate state and federal estate, inheritance and generation skipping transfer taxes payable upon the beneficiary's death. Such fractional share shall be determined as if any power of appointment granted to the beneficiary (under this provision or otherwise) is not exercised and such taxable termination would otherwise occur.

This particular clause is very basic and has no ordering rule and no preference for any particular assets over which the GPOA would apply (e.g., as discussed herein, it would ideally apply to depreciable assets, collectibles, lower basis assets, then cash, IRD, and lastly to any loss assets that would step down in basis, etc.). Again, like the very basic formula GPOAs over GST non-exempt trusts, it probably works just as well in many cases where a cap is not needed and it is likely to be 0% or 100%, and involve no loss assets. However, why risk this? See the following for a more nuanced approach incorporating both these ideas.

**Spousal waiver for INGs to prevent argument there is a grantor trust based on spousal interest, to prevent *Kloiber/Dahl* arguments upon divorce, or to help ensure completed gift for DAPTs or other irrevocable trusts not naming spouse where completed gift desired**

WAIVER OF CERTAIN RIGHTS

I, the undersigned spouse of settlor, waive all of my rights, title, and interest in any property transferred to the attached \_\_\_\_\_\_\_\_\_\_\_trust dated XX/XX/XXXX (the “trust”), other than as specified therein. This waiver shall apply both to current and inchoate interests that I may have, including, but not limited to, rights to an intestate share, statutory elective share, omitted spouse's share, or share in the nature of dower or curtesy, in the estate or augmented estate of settlor.

This waiver shall also apply to any rights to contest the transfer as a breach of trust or fiduciary duty or under any applicable Uniform Fraudulent Transfers Act, Uniform Fraudulent Conveyance Act or Uniform Voidable Transaction Act including common law remedies such as but not limited to equitable or constructive trusts.

This waiver shall not preclude voluntary appointments or gifts by any powerholder or beneficiary that might later directly or indirectly benefit me through their own independent actions. Nor shall this waiver preclude me from later disclaiming or releasing any such rights.

This waiver shall constitute a third-party beneficiary contract for the benefit of all the beneficiaries of the trust, and these beneficiaries or the trustee of the trust may enforce this waiver by appropriate legal action.

Dated: January 9, 2015

[Signatures and notary clause]

[Note: Each state may have its own requirements for validity of post-nuptial agreements. Would a simple waiver need to fulfill all the requisites under state law for post-nuptial agreements? Perhaps. This would not be the same as ERISA/REA spousal waivers which would be preempted by federal law. Is consideration required? Whether property contributed is separate or marital would probably matter. Spouses generally owe fiduciary duties to each other, beyond the scope of this outline. Any attorney representing both spouses skates on thin ice ethically trying to pull shenanigans like the *Dahl* and *Kloiber* cases illustrate (perhaps even those representing only one spouse if it is marital property). But in many instances a waiver like the above may be desired purely for tax and asset protection reasons - not asset protection from the spouse, but against third party creditors. Like any post-nuptial agreement, there are many situations and even techniques and other planning that can be done to ensure such waivers are not in any way abusive to spouses.

**Provision in will (or, potentially, revocable living trust, but usually in will) to exercise a power of appointment**

Property Subject to Certain Powers of Appointment

I am granted a power of appointment (“First Power”) under paragraph \_\_\_\_\_ of the \_\_\_\_\_\_\_\_\_\_\_\_ Trust dated XX/XX/XXXX. I am granted a power of appointment (“Second Power”) under paragraph \_\_\_\_\_ of the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Trust dated XX/XX/XXXX.

[if the power is a general power, or limited power designed to trigger the Delaware Tax Trap, and if the power is not capped, such that exercise or even mere existence of the power may cause a state or federal estate tax, query whether you would want to equitably apportion such taxes, or perhaps apportion such taxes to the residuary or other assets]

(1) I exercise the First Power by directing that, all of the trust estate subject to the First Power shall be distributed to the Trustee of the James Jones Trust dated XX/XX/XXXX;

(2) I exercise the Second Power by directing that, upon my death all of the trust estate subject to the Second Power shall be distributed to the Trustee of the James Jones Trust dated XX/XX/XXXX, subtrust fbo charity pursuant to Article V; and

Here is an example of a Delaware Tax Trap savings clause, which may not be needed in some states/circumstances, and of course may not be desired in others where you are actively trying to trigger §2041(a)(3):

[Notwithstanding anything to the contrary, if my exercise of any of the above powers of appointment (“exercised power”) creates another power of appointment(s) (“new power(s)”), the new power(s) shall not be exercisable and may not postpone the vesting of any estate or interest in, or suspend the absolute ownership or power of alienation of, any property appointed pursuant to the exercised power (or any successor proceeds of such property), beyond the rule against perpetuities applicable to the exercised power.]

Best Practice Pointers When Exercising a *Limited* Power of Appointment

***Specificity of Instrument***

1. Ensure the instrument references the trust agreement specifically, and possibly if there are separate trust shares applicable, the article or paragraph of the trust. Most states require specificity – it can’t hurt regardless. Unique today with increasing use of decanting, include any trust to which the intended trust with the appointive assets is ever decanting into. E.g., “Pursuant to the XYZ Trust dated 9/9/1999, I was granted a limited power of appointment. I hereby exercise my power of appointment over the assets in the XYZ Trust, *including any trust over which I have a power that is comprised of the assets formerly in the XYZ Trust which were transferred pursuant to amendment, bifurcation, severance, distribution, reformation, decanting or otherwise*, as follows…
2. ***Permissible appointees.*** Check the donor’s class of permissible appointees:

a. Resolve any ambiguities in definition of any class of appointees (adopteds, requirement of a lawful marriage, children of the new biology, half-sibling, etc).

b. If a potential appointee is dead, does a state anti-lapse statute or perhaps even the new Uniform Power of Appointment Act if passed in state perhaps permit appointment to the issue of the dead potential appointee?

c. Confirm that power holder’s (donee’s) intended appointees is within the donor’s appointees. This is a big one – you have to get a copy of the ORIGINAL trust. E.g. if H establishes trust w/LPOA for W, who then uses her LPOA to appoint in trust for Child w/LPOA. You represent child and are updating child’s estate plan – you need to review H and W’s trust to see who the universe of potential appointees were – it matters whether the appointments were general or limited.

3. Confirm there is no quid pro quo, “fraud upon the power”.

*If the appointment will be in trust, add the following additional considerations:*

4. Do you want to ***trigger*** the Delaware Tax Trap or not? If so, confirm whether your trust has a savings clause that might prevent this (see example in outline), and if so consider a non-judicial settlement agreement can change this. Then, research whether your state law requires the appointive trust to contain a PEG power (and if so, can it be curtailed), or whether it can be triggered by granting a testamentary GPOA or even another limited power of appointment, as discussed herein with states such as Arizona.

If it is desired to ***avoid*** the Delaware Tax Trap, then be especially careful to avoid adding presently exercisable general powers of appointment in trusts (e.g. “five and five powers”), which is likely to trigger the trap in most states, even those with carefully crafted savings clauses.

Where the appointive property is being transferred to a trust which *already* owns assets, that will have a different RAP period, segregate appointive assets and owned assets into separate trusts. This can avoid various problems. The Rule Against Perpetuities may be different under the donor’s trust and under the donee’s trust. Tip: Specifically provide that the appointive property being added to an existing trust continues to be subject to the RAP originally applicable to that property.

5. Check for Ineffective gift-in-default provisions in the appointive trust. The default takers under the donor’s instrument that created the power, and in the donee’s trust, can be different. It is not a valid exercise to subject the appointed property to the donee’s gift-in-default provision, where the recipients under that provision include potential takers-in-default not within the donor’s gift-in-default provision (or otherwise within the donor’s

class of permissible appointees). E.g. H establishes trust for W w/LPOA to appoint to descendants. W appoints to trust for child w/LPOA, w/default to issue then charity (not to siblings or descendants of H). Child has no issue. The charity as taker in default is invalid.

ELECTION UNDER TREAS. REG. §1.642(c)-1(b) TO TREAT CHARITABLE CONTRIBUTIONS AS PAID IN PRECEDING TAXABLE YEAR (Attachment to 2016 Form 1041 Fiduciary Income Tax Return or Amended Return)

[Trustee Name], Trustee of the [Trust Name] identified below, hereby elects under §642(c)(1) and Reg. §1.642(c)-1(b) to treat a charitable contribution made in the tax year ending December 31, 2017, as made in the preceding tax year ending December 31, 2016. As required by the regulation, the trustee provides the following information with respect to the election:

Name and Address of Fiduciary:

[Trustee Name], Trustee

[Trust Name], [Taxpayer ID Number]

[Trustee Address]

The trustee hereby elects pursuant to Reg. §1.642(c)-1(b) to treat the 2017 charitable contributions described below as if made in 2016.

Date Contributions Name/Address of Donee

1. 08/08/2017 $50,000 cash to Greater Cincinnati Foundation

200 W 4th St, Cincinnati, OH 45202

[Trust Name]

By: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

[Trustee Name and Officer Name if Corporate Trustee]

Trustee

Date: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. Portions of this outline were presented at various CLEs 2011-2018 and were published in Trusts and Estates, Leimberg LISI Estate Planning Newsletter or CCH Estate Planning Review. © 2011-2022 Edwin P. Morrow III – Contact: [*edwin.morrow3@gmail.com*](mailto:edwin.morrow3@gmail.com). Not all portions have been updated to reflect the increasing applicable exclusion amounts due to TCJA for 2018-2025, or for minor inflation adjustments. See this website for further updates and cite paper to this address: <http://ssrn.com/abstract=2436964>. [↑](#footnote-ref-2)
2. No trademark claimed, “Super-Duper Charged Credit Shelter Trust” was apparently unavailable. Attorneys have adopted many names for basis optimizing: “basis harvesting trust”, “basis protection trust”, “optimal benefit trust” [↑](#footnote-ref-3)
3. Section 303 of Public Law 111-312, known as the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. [↑](#footnote-ref-4)
4. Latest inflation adjustments for estate/gift/GST exclusion amount increasing to $11.4 million, as well as increases for income tax brackets and other tax items are in Rev. Proc. 2018-57, §3 [↑](#footnote-ref-5)
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 [↑](#footnote-ref-6)
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. [↑](#footnote-ref-7)
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 or under an alternate valuation date. IRC §§691(c), 1014, 2032, 2032A, and some receive de facto step up (Roth IRA, life insurance) [↑](#footnote-ref-8)
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. [↑](#footnote-ref-9)
9. IRC §121, discussed further in Part VIII of this outline [↑](#footnote-ref-10)
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 [↑](#footnote-ref-11)
11. I will avoid the probate/non-probate revocable trust v. will debate, since probate costs and fees will vary from state to state. A bypass or marital trust might be a testamentary trust under a will. [↑](#footnote-ref-12)
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 significant practical enforcement complexities [↑](#footnote-ref-13)
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 – but beware - many retirement plan documents vest the spouse *before* the one year required by statute. This can be waived *after* marriage, but most courts follow Treas. Reg. §1.401(a)-20, holding a waiver in a prenup to be invalid [↑](#footnote-ref-14)
14. See, e.g., Uniform Probate Code §2-201 et seq. [↑](#footnote-ref-15)
15. Maryland added portability starting in 2019. See HB 308, modifying MD Tax-Gen Code § 7-309. [↑](#footnote-ref-16)
16. 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) [↑](#footnote-ref-17)
17. IRC §2010(c)(5); Treas. Temp. Reg. §20.2010-2T(a). [↑](#footnote-ref-18)
18. 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 the election or it is not valid (trap!). Treas. Reg. §20.6018-2 [↑](#footnote-ref-19)
19. The IRS clarified this distinction in regulations at 80 FR 34279. See e.g. PLR 2016-52007 and PLR 2016-53016. By contrast, it will not grant relief where a return was required –see IRS CCA 2016-50017. Most recently, the IRS in Rev. Proc. 2017-34 announced it will simplify the process of granting relief for those instances when a return was not required and eliminated the requirement that an executor seek a PLR to file a late estate tax return electing portability, if the decedent was a U.S. citizen or resident, and the executor files an estate tax return before the second anniversary of the decedent's death, stating that it is being filed under this new rule. The executor must state at the top of the form that the return is “FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER §2010(c)(5)(A).” An executor who fails to file under this procedure within the first two years after the date of death can still request relief by filing a PLR request. [↑](#footnote-ref-20)
20. 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) [↑](#footnote-ref-21)
21. 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 $5.45 million after John dies, she retains her own $5.45 exclusion, and when Husband #2 dies, she can gift another $5.45 million while retaining her own exclusion, ad infinitum. [↑](#footnote-ref-22)
22. 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 probably overridden state law defaults and the IRS would respect the marital trust and hence add enough assets to Jane’s estate to use both exemptions (including GST). State laws differ on this point, but many have passed the [Uniform Simultaneous Death Act](https://www.uniformlaws.org/committees/community-home?CommunityKey=09a6e8d3-0ee6-4b94-bd85-2386ed145502), or the Uniform Probate Code or have other statutes, e.g., [NY EPTL § 2-1.6](https://codes.findlaw.com/ny/estates-powers-and-trusts-law/ept-sect-2-1-6.html) that may inform the issue. 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? [↑](#footnote-ref-23)
23. IRC §2207A, see § 2207 for marital GPOA; for an example of state law equivalent, see Ohio R.C. 2113.86(I). [↑](#footnote-ref-24)
24. *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.” [↑](#footnote-ref-25)
25. **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 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 (does the spouse give up a mandatory income interest if funds pass to the bypass trust or not?), unless the filing were mandated in the document (in this example that would be the best route). Even if an independent party is named, it may be best to outline parameters or indemnify the executor from diverse ranges of elections selected. See appendix for a drafting example. This technique would be difficult to use for non-probate, non-trust assets such as qualified plans, IRAs etc., so it’s hardly a universal planning option. [↑](#footnote-ref-26)
26. 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 Form 706, it is recommended that timely Forms 706 be filed for any substantial estates. [↑](#footnote-ref-27)
27. Despite the general common law rule espoused by the Uniform Disclaimer of Property Interest Act (see § 6 and § 13 and commentary), 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 state Supreme Court decision (*Stein v Brown*), with Ohio R.C. §5815.36(N), effective March 2013, to protect debtor/disclaimants. Disclaimers cannot avoid tax liens. *Drye v. United States*, 528 U.S. 28 (1999). [↑](#footnote-ref-28)
28. Treas. Reg. §25.2518-2(c)(4)(iii), even though IRC §2040(b) would deem 50% to be in each spouse’s estate. [↑](#footnote-ref-29)
29. If spouse in role as trustee/executor causes his/her mandatory income right to be removed, there is an argument that this causes a taxable gift (see the *Regester* case discussed later herein). If the surviving spouse is deemed a transferor of the bypass or QTIP trust, could this impair asset protection as self-settled trust and estate inclusion? [↑](#footnote-ref-30)
30. <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P204318> - 2% or more jumps happened several times within rather short time frames in the late 70s, early 80s. [↑](#footnote-ref-31)
31. IRC §1014(b)(6),(9), (10). [↑](#footnote-ref-32)
32. See Rev. Rul. 68-554; Treas. Reg. §20.2056(c)-2(b)(1), but see unique applications for step up in basis planning discussed in Part V. [↑](#footnote-ref-33)
33. IRC §2056(b)(5), Treas. Reg. §20.2056(b)(5)(g). [↑](#footnote-ref-34)
34. At IRC §2056(b)(7) and IRC §2056(b)(5) respectively. [↑](#footnote-ref-35)
35. 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. [↑](#footnote-ref-36)
36. Under IRC § §1014(b)(9), not IRC §1014(b)(10). For an example of GPOA marital receiving a new basis on surviving spouse’s death even when the first spouse’s estate is not settled and survivor’s trust not yet funded, see *Connecticut Nat'l Bank v. United States*, 937 F.2d 90 (2d Cir. Conn. 1991) [↑](#footnote-ref-37)
37. See, *The General Power of Appointment Trust is Back,* Bruce Steiner, LISI Estate Planning Newsletter #2060 (February 6, 2013). [↑](#footnote-ref-38)
38. See *Christopher Denicolo, Alan Gassman & Ed Morrow on Revenue Procedure 2016-49: The IRS Finally Puts Planners at Ease on the Validity of "Unnecessary" QTIP Elections,* LISI Estate Planning Newsletter #2464 (Oct. 13, 2016). [↑](#footnote-ref-39)
39. IRS Rev. Proc. 2001-38, see also PLRs 2009-18014, 2007-29028, 2010-36013, voiding valid QTIP elections. [↑](#footnote-ref-40)
40. Compare, e.g., IRS Field Service Advice Memo 2001-19013, *Estate of Aldo H. Fontana v. Comm.*, 118 T.C. 318 (2002)(stock shares in trust with decedent holding testamentary general power of appointment combined with shares held by decedent outright at death for valuation purposes) with *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. Tex. 1996), *Estate of Ethel S. Nowell v. Comm.*, T.C.M. 1999-15 (1999), *Estate of Ambrosina Blanche Lopes v. Comm.*, 78 T.C.M. 46 (1999) (non-aggregation for valuation at death, QTIP valued separately), *Mellinger v. Comm.*, 112 T.C. 26 (1999) (QTIP valued separately), IRS Action on Decision 1999-006. Although this paper assumes most 100% owned LLCs would not receive *any* discount, this may not always be the case for a variety of reasons, notably the transaction costs to convert to outright form of ownership, potential liability of the entity and lease agreements (with above market long-term leases, the entity could be valued *more than* the underlying property). For discounts applied to 100% owned companies see *Estate of Bennett v. Commissioner*, T.C. Memo 1993-34 (15% discount for lack of marketability), and various other cases cited therein. [↑](#footnote-ref-41)
41. A trust that would otherwise qualify as a QTIP that included a testamentary formula GPOA would not qualify for the marital without a QTIP election because to qualify, the power must be exercisable over the entire amount, alone and “in all events”, immediately after death, not subject to conditions – see Treas. Reg. §20.2056-5(a)(3), (a)(4) and (g)(1). [↑](#footnote-ref-42)
42. See separate presentation and material by author. [↑](#footnote-ref-43)
43. Although the general rule is that RMDs are required post-mortem, there is a limited exception and permitted delay for spousal conduit trusts (where the spouse is considered the sole “designated beneficiary”), where the decedent died before his/her required beginning date. IRC §401(a)(9)(B)(iv) “Special rule for surviving spouse of employee.— If the designated beneficiary referred to in clause (iii)(I) is the surviving spouse of the employee—(I) the date on which the distributions are required to begin under clause (iii)(III) shall not be earlier than the date on which the employee would have attained age 70 ½”. If QTIP is elected, a typical trust will require that the minimum of net income from the IRA and the trust separately must be paid – even when there is NO RMD. [↑](#footnote-ref-44)
44. IRC §2056(b)(7)(B)(ii). [↑](#footnote-ref-45)
45. 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. [↑](#footnote-ref-46)
46. IRC §2207A. States also have their own variants that affect QTIPs, such as Ohio R.C. §2113.86(I). [↑](#footnote-ref-47)
47. IRC §6018 (filing threshold), §6035 (Form 8971) and Treas. Prop. Reg. § 1.1014-10(c)(3)(i)(B) “zero basis”. [↑](#footnote-ref-48)
48. This is known as a collateral power, See *Restatement Property, Third, Donative Transfers*, §17.3, comment f. [↑](#footnote-ref-49)
49. 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. [↑](#footnote-ref-50)
50. 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. [↑](#footnote-ref-51)
51. 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 federal court denied the marital deduction, because the trust did not authorize her to receive funds outright or grant a GPOA. Could the IRS use a similar argument re income tax? I think so, unless state law to terminate the trust is closely followed. See also *Stansbury v. U.S.*, 543 F. Supp. 154 (N.D. Ill. 1982) – funds held in constructive trust for another held not to be in a decedent’s estate. [↑](#footnote-ref-52)
52. See PLRs 2019-32001 through 32010, CCA 202118008. See also [*Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations*](https://leimbergservices.com/all/LISIMorrowPDF10_9_2019.pdf)*,* LISI Estate Planning Newsletter #2753 (October 9, 2019)*.* [↑](#footnote-ref-53)
53. 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). [↑](#footnote-ref-54)
54. E.g., Ohio, http://www.actec.org/public/Documents/Studies/Bart\_State\_Decanting\_Statutes\_11\_18\_13.pdf. [↑](#footnote-ref-55)
55. *Identifying and Respecting the Core Elements of a Modern Trust*, comments by Ronald Aucutt, 48th Annual Heckerling Institute on Estate Planning ¶1305.1[B]. [↑](#footnote-ref-56)
56. IRC §2041(b)(1)(C)(ii). [↑](#footnote-ref-57)
57. 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. [↑](#footnote-ref-58)
58. Treas. Reg. §20.2056(b)-7(b)(3). [↑](#footnote-ref-59)
59. Treas. Reg. §20.2056(b)-7(b)(2). [↑](#footnote-ref-60)
60. In many cases, an IRA would not 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 as potential appointees. 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. [↑](#footnote-ref-61)
61. 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. Advisors to the 99% should consider *REDUCING* discounts to FLPs/LLCs by amending operating agreements (adding put/termination rights, etc.), despite articles stating essentially “you can just reduce the discount you take”, which is *absolute nonsense*. [↑](#footnote-ref-62)
62. 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. [↑](#footnote-ref-63)
63. 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 formula GPOA context are PLR 2001-23045, 2000-101021, 2002-10051, 2004-03094, 2006-04028 (discussed in Part V), PLRs 9110054 and 9527024 (discussed extensively later in this Part). If a decedent dies with an unexercised 5/5 power, it’s clear that 5% is included in estate, and 5% is stepped up or down pro rata accordingly. *Prokopov v. Commissioner*, 166 F3d 1201 (2nd Cir. 1998). [↑](#footnote-ref-64)
64. Formulas tied to tax exemption have always been used for AB/GST funding, and 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. See other formulas blessed in Rev. Rul. 64-19 (A/B trusts), Treas. Reg. §26.2632-1(b)(4), (b)(2)(11) and (d)(1) (GST formula allocation); Treas. Reg. § 1.644-2(a)(1)(iii); Rev. Rul. 72-395, 1972-2 C.B. 340; Treas. Reg. § 20.2055-2(e)(2)(vi)(a)(split interest charitable trusts); Treas. Reg. § 25.2702-3(b)(1)(ii)(B)(Formula transfers to a GRAT), and other PLRs discussed herein such as PLR 2006-04028 and PLR 2004-03094 which both had formula general powers of appointment. [↑](#footnote-ref-65)
65. IRC §1022. [↑](#footnote-ref-66)
66. See IRS Chief Counsel Memorandum (CCM) 2006-44020 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 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 the formula apply to specific assets based on date of death or AVD value. [↑](#footnote-ref-67)
67. Analogy to fiduciary’s distribution of specific assets pursuant to specific bequest/devise under IRC §643(e)(4) [↑](#footnote-ref-68)
68. 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). [↑](#footnote-ref-69)
69. *Restatement, Third, Property, Wills and Other Donative Transfers* §17.1, see also Uniform Powers of Appointment Act, §102(13) [↑](#footnote-ref-70)
70. See comment g in *Restatement, Third, Property, Wills and Other Donative Transfers* §17.1 [↑](#footnote-ref-71)
71. Rev. Proc. 64-19, which has to do with post-mortem gains/losses when distributing in kind based on DOD value [↑](#footnote-ref-72)
72. Perhaps a solution to this aspect would be to have a different takers-in-default provision for assets subject to a GPOA lapse than for assets subject to an LPOA lapse, making the trustee’s choice have real effect on property rights. An example would be to instruct the trustee of the subtrusts to exhaust funds funded via GPOA lapse first, similar to traditional clauses in bypass/QTIP and GST exempt/non-exempt bifurcated trusts that encourage spending from non-exempt/QTIP assets prior to GST exempt. [↑](#footnote-ref-73)
73. 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 e.g. 40%. If the trust owned 100% or 51% of the LLC, it may apply to a greater number of shares/membership interests. [↑](#footnote-ref-74)
74. There are examples in the marital trust regulations of general testamentary powers of appointment over ¼ of a trust, and over only 100 shares out of 250 shares of stock. Treas. Reg. §25.2523(e)-1(c)(5), examples 2 and 3. [↑](#footnote-ref-75)
75. IRC §6018(a). [↑](#footnote-ref-76)
76. Treas. Reg. § 1.1014-3. [↑](#footnote-ref-77)
77. See, *Gifts by Fiduciaries by Tax Options and Elections*, November/December 2004 issue 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 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. [↑](#footnote-ref-78)
78. Restatement, 3d, Trusts, §79(2), §183, Uniform Trust Code §803, Bogert’s Trusts and Trustees, Ch. 26 § 541 [↑](#footnote-ref-79)
79. Treas. Reg. §25.2514-1(b)(1) [↑](#footnote-ref-80)
80. See discussion of multiple cases in *Asset Protection Dangers When a Beneficiary Is Sole Trustee and Piercing the Third Party, Beneficiary-Controlled, Irrevocable Trust*, LISI Asset Protection Newsletter #339 (March 9, 2017). As a whole, practitioners are woefully unaware of the different standards bankruptcy courts use for piercing trusts (or domestic relations courts for counting). For a 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). [↑](#footnote-ref-81)
81. 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 tax inclusion criteria. [↑](#footnote-ref-82)
82. 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 <https://www.h2rcpa.com/uploads/6/3/0/3/63031867/pennsylvania_inheritance_tax_brochure.pdf> for differences between federal and PA estate/inheritance tax. This creates a great loophole for Pennsylvania residents (which should be discussed with anyone planning to otherwise leave assets directly to a Pennsylvania resident). [↑](#footnote-ref-83)
83. 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. [↑](#footnote-ref-84)
84. 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, the vast majority 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. Comm.*, 613 F.2d 1213 (2nd Cir 1979), *Williams v. U.S.*, 634 F.2d. 894 (5th Cir. 1981), *Boeving v. U.S.*, 650 F.2d. 493 (8th Cir. 1981), *Estate of Gilchrist v. Comm*. 630 F.2d 340 (5th Cir. 1980) *Doyle v. U.S.*, 358 F. Supp. 300 (E.D. Pa 1973), *Pennsylvania Bank & Trust Co. v. U.S.,* 451 F. Supp. 1296 (W.D. Pa. 1978), aff’d 597 F.2d 382 (3rd Cir. 1979), *Estate of Alperstein v. Comm.*, 71 TC 351 (1978), aff’d 613 F.2d. 1213 (2nd Cir 1979), *Estate of Freeman v. Comm.*, 67 T.C. 202 (1979) (Decedent power holder never saw the trust instrument and was never informed about, and had no actual knowledge of, his rights under the trust). See also Rev. Ruls 75-350 (the surviving spouse's mental capacity is irrelevant in determining the availability of the marital deduction under section 2056(b)(5)); Rev. Rul.75-351. One outlier contrary decision that was criticized in the above cases, in which the court found that an incompetent person did NOT have a general power of appointment was *Finley v. United States*, 404 F. Supp. 200 (S.D. Fla. Dec. 2, 1975) vacated on jurisdictional grounds, 612 F.2d 166 (5th Cir. 1980). However, in *Round v. Comm*, 332 F.2d 590 (1964), correctly decided in my opinion, the trust instrument itself stated that the trust powers (which were a *de facto* GPOA) could not be exercised if a power holder was ruled incompetent. Where a decedent was ruled incompetent prior to death, it was not a GPOA. [↑](#footnote-ref-85)
85. IRC §2056(b)(5), Treas. Reg. §20.2056(b)(5)(g) “The power is not “exercisable in all events”, if it can be terminated during the life of the surviving spouse by any event other than her complete exercise or release of it.” This language is also why a surviving spouse probably can’t simply let 5% of a GPOA in a GPOA marital trust lapse every year to let it escape estate tax altogether after 20 years or so. But, see the cases and rulings cited on page 46, footnote 115. Regardless, the main thrust of OBIT clauses is to *avoid* forcing the marital deduction. [↑](#footnote-ref-86)
86. 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, §305. Of course, that is the conservative drafting route – arguably potential appointees should not be considered   
    “beneficiaries” at all in trying to identify the individual beneficiaries of a trust for see through trust purposes. Update: proposed regulations updating retirement plan see through trust rules pursuant to the Secure Act were issued on February 22, 2022 and (if made final) confirm that mere potential appointees are not counted as beneficiaries unless and until there is an actual appointment. Prop. Reg. §1.401(a)(9)-4. This should encourage practitioners to expand the usage of powers of appointment in see through trusts. [↑](#footnote-ref-87)
87. 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. PLR 8836023: “In the present case, the descendants of the trustor who are the beneficiaries of the trust will be given a testamentary power to appoint to the creditors of the beneficiaries estates or to the beneficiaries' own descendants, or partially in favor of one or more persons from both classes of beneficiaries. The power of appointment that will be given to the beneficiaries will be a general power of appoint because they have a power to appoint to the creditors of their estates. Since the entire trust corpus will be subject to disposition through the exercise of the power the beneficiaries' estates shall include the value of all property subject to the general power of appointment.” Despite the plain language of the statute and the above authority, there are some who bizarrely claim that a power to appoint to creditors is only a general power to the extent that someone’s debt. Good luck with that argument! Someone can always create a creditor and debt through a simple contract with infinitesimal consideration, which is why Congress deemed such a power to be the equivalent of outright ownership. [↑](#footnote-ref-88)
88. IRC §2041(b)(1)(C)(ii), Treas. Reg. §20.2041-3(c)(2): “Such power is not considered a general power of appointment if it is not exercisable by the decedent except with the consent or joinder of a person having a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of the decedent, his estate, his creditors, or the creditors of his estate. An interest adverse to the exercise of a power is considered as substantial if its value in relation to the total value of the property subject to the power is not insignificant.” As for spousal POAs, see also Rev. Rul. 82-156. [↑](#footnote-ref-89)
89. Paraphrasing *Estate of Towle v. Commissioner*, 54 T.C. 368 (1970), which found that a corporate trustee was not adverse despite its duties to remaindermen who were. 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]”. A taker in default of appointment has an adverse interest. An interest is adverse and is considered substantial if its “value in relation to the total value of the property that is subject to the power is not insignificant and is valued in accordance with the actuarial principles of Treas. Reg. §20.2031-7”. Treas. Reg. §20.2041-3(c)(2). [↑](#footnote-ref-90)
90. Rev. Rul. 79-63 – a somewhat dubious ruling in light of Treas. Reg. §20.2041-3(c)(2), but you can rely on it if you keep your facts close, unlike a PLR. Key differentiating points in the ruling – first, it was a lifetime power, second, the ruling stated that “If, however, A (the consenting child who was a remainderman and potential appointee) had been the decedent's only child, A would have had a vested interest in the trust remainder that would have been substantially adverse to the exercise of the decedent's lifetime power of appointment. See *Commissioner v. Prouty*, 115 F.2d 331 (1st Cir. 1940); *Newman v. Commissioner*, 1 T.C. 921 (1943) in such case the child’s interest would be sufficiently adverse.” [↑](#footnote-ref-91)
91. insolven However, I prefer naming other non-adverse parties rather than trustees or courts for simplicity in drafting, more certain result and potentially asset protection differences (might a rogue court compel trustee acquiescence based on indirect fiduciary duty?) [↑](#footnote-ref-92)
92. E.g. *Midwest Trust Company et al. v. Reed Brinton*, 331 P.3d 834 (Kan. Ct. App. Aug. 15, 2014), wherein an attempted exercise of a general power was void and ineffective because the powerholder failed to obtain permission of the trust protector as required by the trust instrument, which contained this clause: "[T]he *validity* of the exercise of [Wendy's] power of appointment *shall be conditioned upon the presentation* by [Wendy] of her last Will purporting to exercise such power to the 'Trust Protector' (*as hereinafter defined*) during the lifetime of [Wendy], and the written approval by such Trust Protector of the proposed exercise after taking into consideration the tax and related consequences thereof, which approval shall not be unreasonably withheld. Any such written approval shall be filed with the records of the trust." (Emphasis added.) This is in spite of the fact that the power holder’s attorney who was the successor trust protector approved it, and the acting trust protector never had a chance to. [↑](#footnote-ref-93)
93. *Picciano v. United States*, 532 F. Supp. 246 (S.D. Ohio 1981). [↑](#footnote-ref-94)
94. Id. [↑](#footnote-ref-95)
95. Treas. Reg. §20.2041-3(b). [↑](#footnote-ref-96)
96. 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 regulations, 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 new 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. [↑](#footnote-ref-97)
97. IRC §1014(c), IRC §691. [↑](#footnote-ref-98)
98. 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? [↑](#footnote-ref-99)
99. A “consenting party” should probably be as liberally found as a GPOA powerholder, following the jurisprudence cited in footnote 81 above that liberally finds such powers to be general. [↑](#footnote-ref-100)
100. For a creditor-friendly state, see 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.” Many more states, however, are debtor-friendly on this point and probably follow common law, see [South Dakota Codified Laws §55-1-26](http://sdlegislature.gov/Statutes/Codified_Laws/DisplayStatute.aspx?Type=Statute&Statute=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.” Rhode Island: § 34-22-13: “*Powers as subjecting property to creditors*: Except to the extent that a donee shall appoint to his or her estate or to his or her creditors, §§ 34-22-11 and 34-22-12 shall not be construed to subject to the claims of creditors of the donee the property which the donee is authorized to appoint.” Similar, Alaska Stat. § 34.40.115, New York: [N.Y. EPTL § 10-7.4](http://codes.findlaw.com/ny/estates-powers-and-trusts-law/ept-sect-10-7-4.html). [Mo. Rev. Stat § 456.1105](http://revisor.mo.gov/main/OneSection.aspx?section=456.1105&bid=33689&hl=): “2. Appointive property subject to testamentary or not presently exercisable general power of appointment created by a person other than the powerholder is not subject to a claim of a creditor of the powerholder or the powerholder’s estate.” [Va. Code §§ 64.2-2736](https://vacode.org/64.2-2736/): “B. Appointive property subject to a general power of appointment exercisable at the powerholder’s death is not subject to a claim of a creditor of the powerholder or the powerholder’s estate except to the extent that the power is exercised in favor of the powerholder’s estate.” [Minn. Stat. § 502.86, Subd. 4](https://www.revisor.mn.gov/statutes/?id=502&view=chapter#stat.502.86): “General power not presently exercisable. Property that is covered by a general power of appointment which, when created, is not presently exercisable, is subject to the payment of the claims of creditors of the donee, the donee's estate, and the expenses of administering the donee's estate only if:(1) the power was created by the donee in favor of the donee; or (2) a postponed power becomes exercisable in accordance with the terms of the creating instrument, except in the case of a testamentary general power.” [Utah Code § 75-1-502](https://le.utah.gov/xcode/Title75/Chapter10/75-10-S502.html): “(1) The property subject to a general or a nongeneral power of appointment not created by the powerholder, including a presently exercisable general or nongeneral power of appointment, is exempt from a claim of a creditor of the powerholder or the powerholder's estate. The powerholder of such a power may not be compelled to exercise the power and the powerholder's creditors may not acquire the power, any rights thereto, or reach the trust property or beneficial interests by any other means. A court may not exercise or require the powerholder to exercise the power of appointment.” See also Mich. Comp. Laws § 556.116 (testamentary general power is accessible only if the power holder exercises or manifests an intent to exercise) and §556.123 (a general power held at death is accessible by the personal representative for creditors regardless of whether the power was ever exercised). [↑](#footnote-ref-101)
101. 11 U.S.C. §541(c)(2). For bankruptcy cases discussing why non-presently exercisable (testamentary) and non-general powers do not usually cause inclusion of appointive assets in a *bankruptcy* estate, see *Casey v. Schneider (In re Behan)*, 506 B.R. 8 (Bankr. D. Mass. 2014), as well as *In re Kinsler*, 24 B.R. 962 (Bankr. N.D. Ga. 1982). [↑](#footnote-ref-102)
102. As of January 2022, the Uniform Power of Appointment Act has been passed in Colorado, Illinois, Kentucky, Missouri, Montana, Nebraska, Nevada, New Mexico, North Carolina, Utah, Virginia, Washington. See [www.uniformlaws.org](http://www.uniformlaws.org). However, because it is a creditor-friendly change of common law, some states may modify the sections that do so, for example, Colorado omitted Section 5 of the Act which would have changed that. I have not checked every state to see which others may have modified this. [↑](#footnote-ref-103)
103. *Restatement of Property, Second, Donative Transfers*, §13.2. Consistent with the Second Restatement is *Page on the Law of Wills* §45.24 (3d Ed. 1962), *Scott and Fratcher, The Law on Trusts* §147.3 (4th Ed. 1987). [↑](#footnote-ref-104)
104. *Restatement of Property, Second, Donative Transfers,* §13.4. [↑](#footnote-ref-105)
105. *Uniform Power of Appointment Act, §502* at [www.uninformlaws.org](http://www.uninformlaws.org), based largely on *Restatement of Property, Third, Donative Transfers*, §22.3. The *Restatement (Third) of Trusts, §56, Comment b*, also attempts to create a creditor-friendly deviation from the Second Restatement and echoes this as well: “A general power to appoint only by will (or by other instrument that is revocable during life) does not give the donee the equivalent of ownership of the appointive assets. Hence, it does not enable creditors of the donee to reach the trust remainder during the donee's lifetime. The advantages of such a power, however, are sufficiently close to beneficial ownership when the power becomes exercisable upon the donee's death that the appointive assets can then be reached to satisfy creditors' claims and other obligations of the deceased donee's estate.” [↑](#footnote-ref-106)
106. See Uniform Probate Code §6-102, comment 3: “The definition of ‘nonprobate transfer’ in subsection (a) includes revocable transfers by a decedent; *it does not include a transfer at death incident to a decedent’s exercise or non-exercise of a presently exercisable general power of appointment created by another person*. The drafters decided against including such powers even though presently exercisable general powers of appointment are subject to the Code’s augmented estate provisions dealing with protection of a surviving spouse from disinheritance. Spousal protection against disinheritance by the other spouse supports the institution of marriage; creditors are better able to fend for themselves than financially disadvantaged surviving spouses. In addition, a presently exercisable general power of appointment created by another person is commonly viewed as a provision in the trust creator’s instrument designed to provide flexibility in the estate plan rather than as a gift to the donee.” [↑](#footnote-ref-107)
107. See discussion of PLR 9110054 in section III.m. below and sample clauses in appendix. [↑](#footnote-ref-108)
108. Some states may have related case law not even in the Restatement, such as the Ohio Supreme Court’s decision in *Schofield v. Cleveland Trust Co.*, 21 N.E.2d 119 (Ohio 1939), protecting non-probate revocable trust assets from probate estate creditors [↑](#footnote-ref-109)
109. <http://tornado.state.co.us/gov_dir/leg_dir/olls/sl2014a/sl_209.htm> (Part 5, which would be Article 5 of the UPAA, being “reserved”). There is other negative “new law” created by the UPOAA – beware your state passing. [↑](#footnote-ref-110)
110. Utah Code §75-10-502. [↑](#footnote-ref-111)
111. Part V.h. discusses the grantor trust differences of exercise/nonexercise of a GPOA under §1.671-2(e). [↑](#footnote-ref-112)
112. See various clauses in appendix. [↑](#footnote-ref-113)
113. Restatement of Trusts, 3d, §57, cmt d. Solvency as a condition precedent [↑](#footnote-ref-114)
114. E.g., see Mich. Comp. Laws §556.115(4), which deems it to be exercisable without consent of a deceased or incapacitated party unless the document states otherwise. [↑](#footnote-ref-115)
115. 11 U.S.C. §541(b)(1), Restatement of Property, Second, Donative Transfers, §13.7 [↑](#footnote-ref-116)
116. See Uniform Probate Code § 2-205(1)(A), with Example 1 in the UPC commentary precisely on point. This section is unaffected by the 2008 proposed amendments to the UPC. It contrasts with presently exercisable or self-created powers. Most do not bring third party created *testamentary* powers into an augmented estate, unless they were accompanied by *presently exercisable* GPOAs, which would be rare and certainly not recommended herein. Many state statutes, like Ohio’s which only applies to probate estate assets, have holes in them wide enough to drive a truck through, but even those non-UPC states with broadly inclusive statutes *exclude* such appointive assets. E.g. see Fla. Stat. 732.2045(h), N.Y. EPTL §5-1.1-A(b)(1)(H) and citations in ACTEC’s recently updated (as of December 2017) survey of state spousal elective share statutes compiled by attorney Alex S. Tanouye: <https://www.actec.org/assets/1/6/Surviving_Spouse%E2%80%99s_Rights_to_Share_in_Deceased_Spouse%E2%80%99s_Estate.pdf>. Since initial publication of this white paper, I did find two statutes that would bring appointive assets under a testamentary general power of appointment under a spousal elective share regime: 1) Michigan, but *only* IF the power is exercised or the power holder “manifests an intent to exercise” and meets other requirements – [MI Comp. Laws §556.116](https://law.justia.com/codes/michigan/2017/chapter-556/statute-act-224-of-1967/section-556.116/) and 2) Delaware at [12 Del. C. § 902](http://delcode.delaware.gov/title12/c009/index.shtml) appears to include everything in the decedent’s gross federal taxable estate in calculating the spousal elective share, which would include appointive assets subject to a general power or limited power triggering the Delaware tax trap. I have not yet reviewed the new ACTEC survey linked to above.

     The general rule in the restatement is at: *Restat 3d Property: Wills and Other Donative Transfers*, § 23.1 *Elective-Share Rights of the Donee's Surviving Spouse in Appointive Assets*

     “For the purpose of determining the elective-share rights of the donee's surviving spouse, property is treated as owned by the donee at death to the extent that the property is subject to:

     (1) a *presently* exercisable general power of appointment exercisable by the donee immediately before death; or

     (2) a general *testamentary* power of appointment exercisable by the donee *if the donee was also the donor of the power*.” Similar is Restat 2d of Prop: Donative Transfers, § 13.7 “Spousal Rights in Appointive Assets on Death of Donee. Appointive assets are treated as owned assets of a deceased donee in determining the rights of a surviving spouse in the owned assets of the donee if the deceased spouse was both the donor and donee of a general power of appointment that was exercisable by the donee alone, unless the controlling statute provides otherwise.” [↑](#footnote-ref-117)
117. 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. [↑](#footnote-ref-118)
118. [Texas Trust Code Section 112.036](https://casetext.com/statute/texas-codes/property-code/title-9-trusts/subtitle-b-texas-trust-code-creation-operation-and-termination-of-trusts/chapter-112-creation-validity-modification-and-termination-of-trusts/subchapter-b-validity/section-112036-rule-against-perpetuities). However, many states have modified the traditional rule. In fact, the Texas statute noted above was recently amended after this original writing, and for trusts with effective dates on or after September 1, 2021, extends the period to a simpler, and longer, 300 years. [↑](#footnote-ref-119)
119. See Howard Zaritsky’s ACTEC compilation 50 State and D.C. Survey of Rule Against Perpetuities Law, specifically pages 8-10 which discuss state law variations, the Uniform Statutory Rule Against Perpetuities Act, and common law: <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*, Jonathan Blattmachr and Jeffrey Pennell, 68 Journal of Taxation 242 (1988), available online at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954062>. While the article did not consider using the DTT for basis planning, this is not the fault of two of the sharpest estate and tax 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. [↑](#footnote-ref-120)
120. See discussion in ACTEC survey and articles cited in the above footnote, which conclude that this should trigger §2041(a)(3) under most states’ RAP. For the common law rule, see Lawrence Berger, *The Rule Against Perpetuities as It Relates to Powers of Appointment*, [41 Neb. L. Rev. 583](https://digitalcommons.unl.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=2748&context=nlr) (1962), page 589 especially:

     “B. REMOTENESS OF THE APPOINTED INTEREST-GENERAL POWER PRESENTLY EXERCISABLE

     No interest created by the exercise of a valid general power presently exercisable is good unless it must vest, if at all, not later than twenty-one years after some life in being at the time of the appointment. Thus if A devises property to B for life, remainder to whom B appoints by deed or will, and B appoints by deed to his son C (unborn at A's death) for life, remainder to C's first son, the remainder to C's first son is valid. It is valid because **in determining the validity of an interest created by the exercise of a general power presently exercisable, the period of the Rule Against Perpetuities is counted from the time of the exercise of the power, and at the time of the exercise C was a life in being. This, of course, is in contrast to the Rule in relation to special and general testamentary powers where the period is computed from the time of the creation of the power.**”

     See, e.g. NY EPTL 10-8.1, [Uniform Statutory Rule Against Perpetuities](https://www.uniformlaws.org/committees/community-home?communitykey=addf3263-af92-4421-a83c-2ef7bc9a1b94&tab=groupdetails) § 2(b), cmt. sub. (b), ex. 2 for proposition that a PEG power starts a new 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 to be the *de facto* owner for estate/gift/GST purposes and it would not be “GST-exempt” absent further planning, but that is the conclusion of many accomplished authors and Treasury’s own examples. Could a power of appointment 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? *Probably* ***not***, because this would not be “presently exercisable”, which under common law means it must not be conditioned on the occurrence of a specified event, the satisfaction of an ascertainable standard, or the passage of a specified period of time. *Restatement Property, 3rd, Donative Transfers*, §17.4. However, this is very state specific, see discussion later herein on pages 53-54: some states may start a new RAP through granting a power that is general for state law purposes but is not for federal tax purposes (IRC § 2041/2514), such as if it is only exercisable with the consent of an *adverse party*. Surprisingly, at common law, as evidenced by the Restatement Second of Property, Donative Transfers, such powers are general. The Third Restatement and the Uniform Power of Appointment Act §205, however, take a contrary view, in trying to align state law with federal tax law. This is discussed further herein. [↑](#footnote-ref-121)
121. See James Casner, *Estate Planning*, §12.2.2.2 n. 6 as well as citations in the footnote above. [↑](#footnote-ref-122)
122. Treas. Reg. §20.2041-3(e)(2). There is a nearly identical *gift* tax regulation at Treas. Reg. §25.2514-3(d). [↑](#footnote-ref-123)
123. 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 *huge* difference in bankruptcy. See 11 U.S.C. § 541(b)(1). [↑](#footnote-ref-124)
124. *Lucas v. Hamm*, 56 Cal.2d 583, 15 Cal. Rptr. 821, 364 P.2d 685 (Cal. 1961) dealt with an attorney sued for failing to recognize a negligently drawn Will that violated the Rule Against Perpetuities. The Supreme Court of California held that the lack of privity between the drafting lawyer and the beneficiaries who were never directly clients did not prevent an action against the attorney. Despite this, the court affirmed the lower court in dismissing the case, finding that it “cannot state causes of action” because the Rule Against Perpetuities was so complex it was beyond the skill of an ordinary attorney! It quoted treatises describing the Rule as a "technicality-ridden legal nightmare" and a "dangerous instrumentality in the hands of most members of the bar". [↑](#footnote-ref-125)
125. See the asset protection effect of PEG powers and lapses 50 state plus D.C. chart in the appendix. [↑](#footnote-ref-126)
126. Remember, in UTC states the applicable creditor access provision, §505(b), refers to “powers of withdrawal”. However, the definition of a power of withdrawal *excludes* any power that is conditioned on consent of the trustee (*unlike* the federal tax code, which still considers that a general power under §2514): UTC §103(11) “Power of withdrawal” means a presently exercisable general power of appointment ***other than a power***: \*\*\*(B) ***exercisable by another person only upon consent of the trustee*** or a person holding an adverse interest.” [if a power were predicated on adverse party consent, it would no longer be a general power of appointment for estate/gift tax]. Interestingly, this provision appears to apply *even if the powerholder happens to be the SOLE trustee*, though I would not count on a court taking a literal reading of the statute for debtor/creditor purposes. [↑](#footnote-ref-127)
127. See *Estate of Tompkins v. Commissioner*, 68 T.C. 912 (T.C. 1977), where a right to withdrawal a lump sum of cash in lieu of a life estate lapsing after 60 days still qualified for the marital deduction, and *Estate of Mackie v. Commissioner*, 64 T.C. 308 (T.C. 1975), aff’d 545 F.2d 883 (4th Cir. 1976) in which a power lapsing after 4 months if not exercised still qualified for the marital deduction. The service acquiesced and later issued Rev. Rul. 82-184, 1982-2 C.B. 215 following these cases. See PLR 2014-10011 in context of prenup. [↑](#footnote-ref-128)
128. IRC §2514(e) – the so called “5 and 5” lapse protection. [↑](#footnote-ref-129)
129. 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. [↑](#footnote-ref-130)
130. Treas. Reg. §20.2041-3(e)(2), there is a nearly identical gift tax regulation at §25.2514-3(d). [↑](#footnote-ref-131)
131. Ohio R.C. §2131.08(D). [↑](#footnote-ref-132)
132. Ohio R.C. §2131.09(F). [↑](#footnote-ref-133)
133. Compare: *Restat 2d of Prop: Donative Transfers*, § 11.4 “*a.  General power of appointment*.  A general power of appointment gives the donee of the power the authority to confer on himself or herself the full benefit of the appointive assets to the exclusion of others. If this authority must be exercised jointly with another, even though the joint donee may have an interest in the appointive assets adverse to the exercise of the power in favor of the donee who can be benefited by the exercise of the power, ***that fact does not prevent the power from being a general one***. Restat 3d Prop.: Wills and Other Donative Transfers, § 17.3 “*e. Joint power with nonadverse party or with adverse party*. If a power of appointment can be exercised in favor of the donee, the donee's estate, or the creditors of either, the power is a general power even if the donee can only exercise the power with the joinder of a nonadverse party. If the power can only be exercised with the joinder of an adverse party, however, ***the power is not a general power***. An adverse party is a person who has a substantial beneficial interest in the trust or other property arrangement that would be adversely affected by the exercise or nonexercise of the power in favor of the donee, the donee's estate, or the creditors of either; a nonadverse party is a person who does not have such an interest.” The Uniform Power of Appointment Act follows the latest restatement. [↑](#footnote-ref-134)
134. In UTC states the applicable creditor access provision, §505(b), refers to “powers of withdrawal” (see 50 state chart). However, the definition of a power of withdrawal under the UTC excludes any power that is conditioned on consent of the trustee (unlike the federal tax code, which still considers that a general power under §2514): UTC §103(11) “Power of withdrawal” means a presently exercisable general power of appointment other than a power: \*\*\*(B) exercisable by another person only upon consent of the trustee or a person holding an adverse interest.” [if a power were predicated on adverse party consent, it would no longer be a general power of appointment for estate/gift tax]. Interestingly, this provision appears to apply even if the powerholder happens to be the SOLE trustee, though I would not count on a court taking a literal reading of the statute. [↑](#footnote-ref-135)
135. 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 statutes (or, depending on the point of view, treacherous, if dealing with an inadvertent appointment and taxable estates), 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. [↑](#footnote-ref-136)
136. 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”. You can find multiple examples of such clauses online from CLEs done decades ago. [↑](#footnote-ref-137)
137. “If the settlor of a trust empowers a trustee or another person to change a power of appointment from a general power into a nongeneral power, or vice versa, the power is either general or nongeneral depending on the scope of the power at any particular time.” Comments to Uniform Power of Appointment Act, §102 [↑](#footnote-ref-138)
138. PLR 9527024 [↑](#footnote-ref-139)
139. [PLR 2004-03094](https://www.irs.gov/pub/irs-wd/0403094.pdf), [PLR 2006-04028](https://www.irs.gov/pub/irs-wd/0604028.pdf) – although these two PLRs involved additional issues discussed later herein regarding JEST trusts and techniques to get a step up in basis at the first spouse to die’s death in a separate property state, they might still be informative as to how the IRS views the scope of IRC 2041 and caps on powers. [↑](#footnote-ref-140)
140. [PLR 202206008](https://www.irs.gov/pub/irs-wd/202206008.pdf). See also, *Ed Morrow on PLR 202206008: Judicial Settlement Modification & Formula Testamentary General Powers of Appointment*, LISI Estate Planning Newsletter #2945 (March 16, 2022). [↑](#footnote-ref-141)
141. *Estate of Kurz*, 101 T.C. 44 (1993), aff’d 68 F.3d 1027 (7th Cir. 1995) – I suggest reading both the district court and appellate court opinions, even though the latter is controlling. [↑](#footnote-ref-142)
142. 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 [↑](#footnote-ref-143)
143. This is essentially paraphrasing the 7th Circuit’s *Kurz* opinion, at page 1029, “ask how much wealth the decedent actually controlled at death”, and the definition of when a general power is determined and measured as such under the restatement – see Restat 2d of Prop: Donative Transfers, § 11.4; Restat 3d Property: Wills and Other Donative Transfers, § 17.3 “*d. Effect of fiduciary exercising authority to change nongeneral power to general power and vice versa*. If the settlor of a trust empowers the trustee or a trust protector to change a donee's general power into a nongeneral power or to change a donee's nongeneral power into a general power, the donee's power is either general or nongeneral depending on the scope of the donee's power at any particular time.” [↑](#footnote-ref-144)
144. Treas. Reg. §20.2056(b)-7(h) Ex 7: [After example of a “zeroed out” QTIP formula]\*\*\* “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.” [↑](#footnote-ref-145)
145. E.g., see the otherwise excellent client-friendly summary of the idea in July 2014 newsletter by the law firm Day Pitney LLP at <http://www.daypitney.com/news/docs/dp_5344.pdf#page=1> [↑](#footnote-ref-146)
146. 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 [↑](#footnote-ref-147)
147. 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. [↑](#footnote-ref-148)
148. 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.” [↑](#footnote-ref-149)
149. E.g., *Estate of Christiansen v. Comm*., 586 F.3d 1061(8th Cir. 2009), there are also examples in Regulations [↑](#footnote-ref-150)
150. The 2014-2015 versions of this white paper missed much of this nuance, and this version corrects a few points on disclaiming PEG powers – thanks to Illinois tax attorney Robert Kolasa for bringing questions on this point to my attention. See his excellent article *Stepped-up Basis for Credit Shelter Trusts Using PEG powers Under Illinois Law,* Illinois State Bar Association Trusts and Estates Newsletter, Vol. 62, No. 10, April 2016 [↑](#footnote-ref-151)
151. IRC §2518(b); Treas. Reg. §25.2518-2(c)(3) “In the case of a general power of appointment, the holder of the power has a 9-month period after the transfer creating the power in which to disclaim. If a person to whom any interest in property passes by reason of the exercise, release, or lapse of a general power desires to make a qualified disclaimer, the disclaimer must be made within a 9-month period after the exercise, release, or lapse regardless of whether the exercise, release, or lapse is subject to estate or gift tax. In the case of a nongeneral power of appointment, the holder of the power, permissible appointees, or takers in default of appointment must disclaim within a 9-month period after the original transfer that created or authorized the creation of the power. If the transfer is for the life of an income beneficiary with succeeding interests to other persons, both the life tenant and the other remaindermen, whether their interests are vested or contingent, must disclaim no later than 9 months after the original transfer creating an interest. In the case of a remainder interest in property which an executor elects to treat as qualified terminable interest property under section 2056(b)(7), the remainderman must disclaim within 9 months of the transfer creating the interest, rather than 9 months from the date such interest is subject to tax under section 2044 or 2519. A person who receives an interest in property as the result of a qualified disclaimer of the interest must disclaim the previously disclaimed interest no later than 9 months after the date of the transfer creating the interest in the preceding disclaimant. Thus, if A were to make a qualified disclaimer of a specific bequest and as a result of the qualified disclaimer the property passed as part of the residue, the beneficiary of the residue could make a qualified disclaimer no later than 9 months after the date of the testator's death.

     \*\*\*  
     Example (1). On May 13, 1978, in a transfer which constitutes a completed gift for Federal gift tax purposes, A creates a trust in which B is given a lifetime interest in the income from the trust. B is also given a nongeneral testamentary power of appointment over the corpus of the trust. The power of appointment may be exercised in favor of any of the issue of A and B. If there are no surviving issue at B's death or if the power is not exercised, the corpus is to pass to E. On May 13, 1978, A and B have two surviving children, C and D. If A, B, C or D wishes to make a qualified disclaimer, *the disclaimer must be made no later than 9 months after May 13, 1978*.  
     Example (2). Assume the same facts as in example (1) except that B is given a *general* power of appointment over the corpus of the trust. B exercises the general power of appointment in favor of C *upon B's death on June 17, 1989. C may make a qualified disclaimer no later than 9 months after June 17, 1989*. If B had died without exercising the general power of appointment, E could have made a qualified disclaimer no later than 9 months after June 17, 1989. [↑](#footnote-ref-152)
152. Treas. Reg. §20.2041-1(d). [↑](#footnote-ref-153)
153. See discussion of these nuances in the Uniform Disclaimer of Property Interests, § 10, example 1 and 2(b) and Uniform Probate Code §2-1110 based thereon. [↑](#footnote-ref-154)
154. These distinctions and effects may vary state to state. See NY EPTL § 2-1.11, which deems a “renunciation” under that statute to be retroactive. The terminology is not as important as the legal effect – is it a transfer by the power holder under state law or not? The Uniform Disclaimers of Property Interests Act § 13(f), Uniform Probate Code as § 2-113(f), provides: "A disclaimer of an interest in property which is barred by this section takes effect as a transfer of the interest disclaimed to the persons who would have taken the interest under this [Act] had the disclaimer not been barred." [↑](#footnote-ref-155)
155. 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*. [↑](#footnote-ref-156)
156. See the *Drye* case, restatement, cases and statutes cited in footnote 24. Notable exceptions to post-disclaimer asset protection include Medicaid look back for improper transfers and federal tax liens. [↑](#footnote-ref-157)
157. Powers of appointment exercised by will (even general) should not subject an estate to additional executor or attorney for executor fees either. *In re Estate of Wylie*, 342 So. 2d 996 (Fla. Dist. Ct. App. 4th Dist. Feb. 4, 1977). [↑](#footnote-ref-158)
158. This is contrary to a *testamentary* power, as discussed in Part III.h. – see citations in that section. [↑](#footnote-ref-159)
159. 5 Del. Code Title 25, § 504, amended by 79 Del. Laws, c. 352 (effective August 1, 2014) [↑](#footnote-ref-160)
160. Also see *Deliberately Violating the Delaware Tax Trap to Achieve a Step-Up in Income Tax Basis*, by Michael Breslow, VOL. XXV, NO. 3, Spring 2016, Philadephia Estate Planning Council, discussing Pennsylvania law, available online at <https://www.htts.com/documents/Del-Tax-Trap.pdf>. For post-2006 trusts this opting into the trap is apparently also available in PA, but for pre-2007 trusts a PEG power would have to be used. [↑](#footnote-ref-161)
161. ARS §14-2905(C), 14-2902(A). 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. [↑](#footnote-ref-162)
162. 25 Del. Code §504 [↑](#footnote-ref-163)
163. Uniform Trust Code §107, see also Restatement, Second, Conflicts of Laws §270 [↑](#footnote-ref-164)
164. For ACTEC compilation of state statutes re: change of law, situs from Gordon, Fournaris & Mammarella, P.A: http://www.actec.org/assets/1/6/Gordon\_Transfer\_of\_Situs\_and\_Governing\_Law.pdf [↑](#footnote-ref-165)
165. E.g., *In re Huber*, 2013 Bankr. LEXIS 2038 (May 13, 2013) [↑](#footnote-ref-166)
166. See *Unconstitutional Perpetual Trusts*, by Steven J. Horowitz and Robert H. Sitkoff, 67 Vand. L. Rev. 1769 (2014), *Jonathan Blattmachr, Mitchell Gans & William Lipkind: What If Perpetual Trusts Are Unconstitutional?* LISI Estate Planning Newsletter #2263, (December 18, 2014) *Steve Oshins: The Rebuttal to Unconstitutional Perpetual Trusts*, LISI Estate Planning Newsletter #2265 (December 22, 2014) available at <http://www.leimbergservices.com>, which discusses potential issues in nine states with constitutional perpetuities restrictions in their constitutions: Arizona, Arkansas, Montana, Nevada, North Carolina, Oklahoma, Tennessee, Texas and Wyoming.  Of these states, Arizona, Nevada, North Carolina, Tennessee and Wyoming have enacted longer-term perpetuity statutes. [↑](#footnote-ref-167)
167. Restatement, Second, Conflict of Laws, §269, comment i: “*i.  Policy of state of testator's domicil at death*.  A trust provision in a will is invalid to the extent that it is invalid under the strong public policy of the state of the testator's domicil at death, even though it would be valid under the local law of the state designated in the will to govern the validity of the trust or under the local law of the state where the trust is to be administered.  
     The mere fact, however, that the provision would be invalid under the local law of the state of the testator's domicil does not invalidate the provision. If the provision is valid under the local law of the state designated by the testator or under the local law of the place of administration, it will be held to be valid if it does not contravene a strong policy of the state of the testator's domicil. ***No such strong policy is involved in rules against perpetuities or rules against accumulations or rules as to indefiniteness of beneficiaries.***

     On the other hand, when a testator who dies domiciled in one state leaves his estate to a trust company in another state in trust to pay the principal to a beneficiary if and when the marriage to the beneficiary's present wife should be dissolved, and the condition is against the strong public policy of the testator's domicil as tending to encourage divorce, it may be held that the condition is illegal, even though it would not be illegal under the local law of the state of administration. Possibly in such a case it would be held that the local law of the beneficiary's domicil would be applicable.”  
       
       
       
      [↑](#footnote-ref-168)
168. This section was updated, overhauled and expanded into a more comprehensive article: *Ed Morrow - The “Disclaim to Gain” Strategy and the Missed Opportunities to Save Income Tax for Jointly Held Marital Accounts and Joint Trusts,* LISI Estate Planning Newsletter #2686 (November 29, 2018)*.* [↑](#footnote-ref-169)
169. IRC §§ 2040 and 1014. [↑](#footnote-ref-170)
170. Reg. §25.2518-2(c)(4)(iii).  [↑](#footnote-ref-171)
171. Reg. §25.2518-2(c)(4)(iii). [↑](#footnote-ref-172)
172. Reg. §25.2518-2(c)(5), Ex. 12 [↑](#footnote-ref-173)
173. Reg. §25.2518-2(e)(2). [↑](#footnote-ref-174)
174. Reg. §25.2518-2(c)(5), Ex. 14 [↑](#footnote-ref-175)
175. There is no specific guidance on the “consideration furnished” test under Reg. §25.2518(c)(4)(iii). However, Reg. §20.2040-1(a)(2) contains a rebuttable presumption that the decedent furnished all the consideration for a joint account. It is unclear to what extent this regulation may influence any interpretation of §2518, which contains no analogous presumption. [↑](#footnote-ref-176)
176. Treas. Reg. §25.2511-1(h)(4), referenced in Treas. Reg. §25.2518-2(c)(4)(iii). [↑](#footnote-ref-177)
177. *Gallenstein v. U.S.*, 975 F.2d 286 (6th Cir. 1992), see also *Hahn v. Comm.*, 110 TC 140 (1998), acq. IRB 2001-42. [↑](#footnote-ref-178)
178. Treas. Reg. §25.2518-2(e)(2). [↑](#footnote-ref-179)
179. 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.” A lifetime LPOA should equally be permitted due to IRC §2519 causing a taxable gift over the entire amount of the transfer, if not the entire trust. A bypass trust, however, can be more targeted. [↑](#footnote-ref-180)
180. 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”) [↑](#footnote-ref-181)
181. See, e.g., the Uniform Powers of Appointment Act, §401 and §404, at [www.uniformlaws.org](http://www.uniformlaws.org), but see Mich. Comp. Laws §556.118(2) for a counterexample. [↑](#footnote-ref-182)
182. Treas. Reg. §25.2518-2(c)(3), which is extensively cited with examples in footnote 123 above. [↑](#footnote-ref-183)
183. IRC §1014(b)(6). States and territories with a default In *Commissioner v. Harmon*, 323 U.S. 44 (1944), the Supreme Court ruled that an Oklahoma statute allowing spouses to elect community property under that state’s law would not be recognized for federal income tax purposes. Accordingly, some commentators argue that the IRS may rely on *Harmon* to disallow the full step-up in basis for community property acquired through an opt-in community property state.

     But other commentators believe that *Harmon*does not affect the community property classification under an opt-in system. In Revenue Ruling 77-359, 1977-1 C.B. 357, the IRS addressed the tax treatment of community property agreements entered into by a husband and wife residing in the State of Washington (a community property state). It concluded that the conversion of separate property to community property by residents of a community property state would be effective for federal gift tax purposes but ineffective for the transmutation of income from such property. The Ruling, citing *Harmon*, noted, “[t]o the extent that the agreement affects the income from separate property and not the separate property itself, the Service will not permit the spouses to split that income for Federal income tax purposes where they file separate income tax returns.” Based on this 1977 Revenue Ruling, the IRS may treat the underlying property as community property and not distinguish between elective and default community property regimes.

     system are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, Wisconsin and Puerto Rico. [↑](#footnote-ref-184)
184. *U.S. v. Elam,* 112 F.3d 1036 (9th Cir. 1997). [↑](#footnote-ref-185)
185. Sixteen states have adopted the Uniform Disposition of Community Property Rights at Death Act as of 2014 (at [www.uniformlaws.org](http://www.uniformlaws.org)), which provides that on the death of a spouse, the community property rights of the estate and survivor will be respected: AK, AR, CO, CT, FL, HI, KY, MI, MN, MT, NY, NC, OR, UT, VA, WY.Other states may honor it under case law: see Restatement, Conflict of Laws, §259, comment b [↑](#footnote-ref-186)
186. E.g., **all** community property may be susceptible to creditors of only **one** spouse! Tex. Fam. Code §3.202(d). [↑](#footnote-ref-187)
187. IRC §2040(b) will limit estate inclusion of “qualified joint interests” such as joint tenancy or tenancy by the entireties to 50% (tenancy in common or more than three owner joint tenancies would be under a different general rule under IRC §2040(a). Community property that also has a right of survivorship would still receive the generally more favorable basis treatment. See Rev. Rul. 87-98. While rarer every day, you have a different rule if you run across joint property purchased pre-1977 per *Gallenstein v. U.S*., 975 F.2d 286 (6th Cir. 1992). For unique planning opportunities to exploit this for joint bank/brokerage accounts using disclaimers, see Part IV of outline. [↑](#footnote-ref-188)
188. Alaska Stat. §34.77.100, Tenn. Code Ann. ch. 35-17, S.D.C.L. ch. 55-17 [↑](#footnote-ref-189)
189. Rev. Rul. 66-283 [↑](#footnote-ref-190)
190. Alaska Stat. §34.77.010 et seq, with the community property trust requirements at §34.77.100 [↑](#footnote-ref-191)
191. IRS Publication #555 “Community Property”, page 2: “***Note.*** This publication does not address the federal tax treatment of income or property subject to the “community property” election under Alaska state laws.” [↑](#footnote-ref-192)
192. Rev. Rul. 87-13 [↑](#footnote-ref-193)
193. *Commissioner v. Harmon*, 323 US 44 (1944): “The important fact is that the community system of Oklahoma is not a system, dictated by State policy, as an incident of matrimony.” This certainly applies to TN/AK CP trusts. [↑](#footnote-ref-194)
194. E.g. David Westfall & George P. Mair, Estate Planning Law & Taxation, §4.01(1) (4th ed. 2001 & Supp. Feb. 2011) (arguing it should not be effective); Jonathan G. Blattmachr, Howard M. Zaritsky & Mark L. Ascher, *Tax Planning with Consensual Community Property: Alaska’s New Community Property Law*, 33 Real Prop., Prob. & Tr. J. 614 (1999) (arguing it should be). The latter has a better legal argument, despite *Harmon*, but it’s uncertain. [↑](#footnote-ref-195)
195. IRS Manual 25.18.1.2.2 (03-04-2011) *Community Property Law*: “Alaska has also adopted a community property system, but it is optional. Spouses may create community property by entering into a community property agreement or by creating a community property trust. See Alaska Stat. §§ 34.77.020 - 34.77.995. The U.S. Supreme Court ruled that a similar statute allowing spouses to elect a community property system under Oklahoma law would not be recognized for federal income tax reporting purposes. *Commissioner v. Harmon*, 323 U.S. 44 (1944). The Harmon decision should also apply to the Alaska system for income reporting purposes.” [↑](#footnote-ref-196)
196. See Restatement, Second, of Conflicts of Laws, §258, comment b, and §270 (regarding trusts). See also Uniform Probate Code §2-703 [↑](#footnote-ref-197)
197. *In re Huber*, 2013 Bankr. LEXIS 2038 (May 13, 2013) [↑](#footnote-ref-198)
198. 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.” [↑](#footnote-ref-199)
199. A postnuptial agreement executed by Ohio residents in a state where it was permissible was held invalid in *Brewsaugh v. Brewsaugh*, 23 Ohio Misc. 2d 19, 491 N.E.2d 748, 1985 Ohio Misc. LEXIS 92 (Ohio C.P. 1985). However, Ohio would recognize community property rights of former community property state residents who later move to Ohio after establishment of the community property. *Estate of Kessler*, 77 Ohio St 136, 138, 203 NE 2d 221 (1964). [↑](#footnote-ref-200)
200. See, e.g., *Hisquierdo v. Hisquierdo*, 439 U.S. 572 (1979) (railroad retirement benefits); *Bunney v. Commissioner*, 114 T.C. 259 (2000) (IRA withdrawals); *In re Marriage of Hillerman*, 109 Cal. App. 3d 334, 167 Cal. Rptr. 240 (1980) (social security benefits); *Free v. Bland*, 369 U.S. 663 (1962) (US savings bonds); Rev. Rul. 87-52, 1987-26 I.R.B. 28, 1987-1 C.B. 347 (Earned income credit), *McCarty v. McCarty*, 453 U.S. 210 (military pay). [↑](#footnote-ref-201)
201. IRC §2040(b). [↑](#footnote-ref-202)
202. *Propstra v. United States*, 680 F.2d 1248 (9th Cir. Ariz. 1982) [↑](#footnote-ref-203)
203. *Estate of Lee v. Commissioner*, 1978 U.S. Tax Ct. LEXIS 165 (T.C. 1978) [↑](#footnote-ref-204)
204. *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. Tex. 1981) [↑](#footnote-ref-205)
205. Rev. Rul. 79-124 permits the inside basis of both halves of LLC/LP interests to be adjusted upwards or downwards with a §754 election to reflect the change at date of death (or alternate valuation date) to the outside basis. Usually, this is favorable, and you may think that no one would ever make a §754 election if it would mean the inside basis would *decrease*. However, this result may be forced upon a taxpayer in two instances:

     1) if the partnership had in prior years already made a §754 election, such as upon a prior death or sale by a partner/member, which is applicable “to all transfers of interests in the partnership during the taxable year with respect to which such election was filed **and all subsequent taxable years**” Treasury regulations do permit a revocation of the election with the approval of the district director of the IRS, but note that “no application for revocation of an election shall be approved when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution.” Treas. Reg. §1.751-1(c); or

     2) if the LLC/LP has a substantial built-in loss immediately after the transfer (more than $250,000), IRC § 743(a) and (d) would require inside basis to be reduced regardless of whether a §754 election is made. [↑](#footnote-ref-206)
206. E.g. [Cal. Civ. Code §682.1](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CIV&sectionNum=682.1.), [Nev. Rev. Stat. §123.250](https://law.justia.com/codes/nevada/2017/chapter-123/statute-123.250/), §[111.064](https://law.justia.com/codes/nevada/2017/chapter-111/statute-111.064/), [Texas Sec. 112.051 et seq.](http://www.statutes.legis.state.tx.us/Docs/ES/htm/ES.112.htm); [Wis. Stat. §766.60(5)](https://docs.legis.wisconsin.gov/statutes/statutes/766/60/5/a), [Idaho Code §15-6-401](https://legislature.idaho.gov/statutesrules/idstat/title15/t15ch6/sect15-6-401/) (real property) and [Idaho Code §15-6-403](https://legislature.idaho.gov/statutesrules/idstat/title15/t15ch6/sect15-6-403/) (personal property); [Ariz. Rev. Stat. § 33-431](http://codes.findlaw.com/az/title-33-property/az-rev-st-sect-33-431.html); [Alaska Stat. § 34.77.110(e)](https://law.justia.com/codes/alaska/2016/title-34/chapter-34.77/section-34.77.110/); [NM Stat § 40-3-8(B)](https://law.justia.com/codes/new-mexico/2017/chapter-40/article-3/section-40-3-8/); [RCW 64.28.010 et seq](http://app.leg.wa.gov/rcw/default.aspx?cite=64.28&full=true#64.28.010). Apparently Louisiana is a holdout. [↑](#footnote-ref-207)
207. Rev. Rul. 87-98, 1987-2 C.B. 206. [↑](#footnote-ref-208)
208. [Texas Sec. 112.052(d)](http://www.statutes.legis.state.tx.us/Docs/ES/htm/ES.112.htm) “A survivorship agreement may not be inferred from the mere fact that an account is a joint account or that an account is designated as JT TEN, Joint Tenancy, or joint, or with other similar language.” [↑](#footnote-ref-209)
209. See PLRs 2001-01021, 2002-10051, 2004-03094, 2006-04028, TAM 9308002. Many 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, including capping a GPOA to an amount able to be soaked up by a power holder’s applicable exclusion amount. Regardless, those with smaller estates probably would not care about loss of the marital deduction and “double use” of exclusion anyway. [↑](#footnote-ref-210)
210. 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. [↑](#footnote-ref-211)
211. Some PLRs in this area used joint trusts, but the same concepts apply either way. [↑](#footnote-ref-212)
212. For an argument that the lifetime GPOA variant is superior, see the excellent article *The Minimum Income Tax Trust*, by James G. Blase, Trusts and Estates, May 2014, which argues that §1014(e) should not apply because there is not a completed gift to the power holder. However, there is an unsettled question whether you can even have an effective GPOA in the donee spouse while the power is revocable by the donor spouse. Because it would essentially be revocable until exercised, there is an argument it’s really only effective with the consent of the creator of the power, which would disqualify it as a GPOA for tax purposes under §2514(c)(3) until it is exercised or the creator releases the power to revoke it. Finding there only to be a creation of a GPOA when the transfer is complete and irrevocable is consistent with qualified disclaimer regulations that hold that the nine-month window runs from when the gift/transfer is complete. Treas. Reg. § 25.2518-2(c)(3). While it is not conclusive for §2041/tax purposes, the Restatement of Trusts seems to imply that such a power is essentially disregarded until exercised, even to the point of being protected from a powerholder beneficiaries creditors while the grantor can revoke: “The other beneficiaries of a revocable trust are treated, for many of these purposes, as if they had no existing property interests (that is, their rights may be treated like the bare expectancies of will beneficiaries) so long as the power to revoke exists. Accordingly, these revocable interests are not reachable by the creditors of those beneficiaries.” *Restatement (Third) of Trusts* § 56, comment b. Note that one of the above-mentioned PLRs, 2002-10051, applied §1014(e) to *deny* a step up in basis even though it involved a *presently* *exercisable* rather than *testamentary* general power of appointment. Therefore, I prefer other methods to optimize step up in basis. [↑](#footnote-ref-213)
213. 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. [↑](#footnote-ref-214)
214. 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. [↑](#footnote-ref-215)
215. Treas. Reg. §25.2511-1(h)(1), see also PLR 9114023 [↑](#footnote-ref-216)
216. 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. [↑](#footnote-ref-217)
217. Treas. Reg. §25.2511-1(e) [↑](#footnote-ref-218)
218. 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. PLR 9026036 would deny the step up altogether but a revision of that PLR, PLR 9321050, would apportion based on the value of the income interest in the trust that the donor would later receive: “Notwithstanding our no ruling position with respect to the basis of the ***income*** interest in the Husband's Trust on the death of Husband, the basis of the ***remainder*** interest presents a different question. Upon the death of Husband, section 2041 will be applicable to any remaining Husband's Trust assets and the entire value of the Husband's Trust will be includible in Husband's gross estate. Accordingly, section 1014(b)(10) will apply, and the basis of the remainder interest in Husband's Trust will be as described in section 1014(a).” [↑](#footnote-ref-219)
219. *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” [↑](#footnote-ref-220)
220. “For example, assume that A gives appreciated property with a basis of $10 and a fair market value of $100 to D within one year of D's death, that D's date of death basis was $20, and that the date of death fair market value of the property was $200. If A is entitled to the property by reason of D's death, A's basis in the property will be $20. If A subsequently sells the property for its fair market value of $200, A will recognize gain of $180. If, instead, the executor sells of the property, distributing the proceeds to A, similar rules will apply and the estate will recognize a gain of $180.

     This rule applies only to the extent that the donor-heir or his spouse is entitled to receive the value of the appreciated property. If the heir or his spouse is only entitled to a portion of the property (e.g., because the property must be used to satisfy debts or administration expenses), the rule applies on a pro-rata basis. Thus, in the above example, if the decedent's estate consisted only of the appreciated property and total estate liabilities were $50, the heir would only be entitled to three-fourths of the appreciated property. Accordingly, the portion of the property to which the donor-heir was not entitled (one-fourth in the example) will receive a stepped-up basis. In such a case, the basis of the appreciated property in the hands of the executor or the heir will be $65 (i.e., one-fourth of $200 (or $50) plus three-fourths of $20 (or $15)).” General Explanation of the Economic Recovery Tax Act of 1981 (H.R. 4242, 97th Congress; Public Law 97-34), Prepared by the Staff of the Joint Committee on Taxation, December 29, 1981, H. Rep. No. 201, 97th Cong., 1st Sess. 188-189 (1981) [↑](#footnote-ref-221)
221. PLR 2011-22007 [↑](#footnote-ref-222)
222. 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.” [↑](#footnote-ref-223)
223. 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.**” [↑](#footnote-ref-224)
224. Treas. Reg. §20.2056(b)-7(c). [↑](#footnote-ref-225)
225. IRC §1014(e)(1). [↑](#footnote-ref-226)
226. There are many regulations under §1014, Treas. Reg. §1.1014-1 to §1.1014-9, none of which add any insight to §1014(e). [↑](#footnote-ref-227)
227. Note, this technique does not work for outright gifts, where donee spouse buys assets from donor spouse, because IRC §1041(b) deems transfers between spouses to be treated as gifts. [↑](#footnote-ref-228)
228. IRC §1014(e)(2)(B). [↑](#footnote-ref-229)
229. Treas. Reg. §1.671-2(e):

     “(1) For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust. \*\*\*\*\*\*\*\*

     (2) (i) A gratuitous transfer is any transfer other than a transfer for fair market value.

     \*\*\*\*

     (5) If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.” [↑](#footnote-ref-230)
230. “This rule applies only to the extent that the donor-heir or his spouse is entitled to receive the value of the appreciated property. If the heir or his spouse is only entitled to a portion of the property (e.g., because the property must be used to satisfy debts or administration expenses), the rule applies on a pro-rata basis. Thus, in the above example, if the decedent's estate consisted only of the appreciated property and total estate liabilities were $50, the heir would only be entitled to three-fourths of the appreciated property. Accordingly, the portion of the property to which the donor-heir was not entitled (one-fourth in the example) will receive a stepped-up basis. In such a case, the basis of the appreciated property in the hands of the executor or the heir will be $65 (i.e., one-fourth of $200 (or $50) plus three-fourths of $20 (or $15)).” General Explanation of the Economic Recovery Tax Act of 1981 (H.R. 4242, 97th Congress; Public Law 97-34), Prepared by the Staff of the Joint Committee on Taxation, December 29, 1981, H. Rep. No. 201, 97th Cong., 1st Sess. 188-189 (1981) [↑](#footnote-ref-231)
231. For a recent scathing rebuke of the IRS using substance over form to recast transactions authorized by the law, see *Summa Holdings, Inc. v. Comm'r*, 2017 U.S. App. LEXIS 2713 (6th Cir. Feb. 16, 2017). [↑](#footnote-ref-232)
232. *Estate of Kite v. Commissioner*, T.C. Memo 2013-43, fn 9. [↑](#footnote-ref-233)
233. The IRS ultimately prevailed in part by nixing a private annuity transaction. See *Jeff Pennell on Estate of Kite: Will It Fly?*, LISI Estate Planning Newsletter # 2062 (February 11, 2013), *Steve Akers on Kite*, LISI Estate Planning Newsletter #2072 (March 5, 2013). [↑](#footnote-ref-234)
234. See LISI Estate Planning Newsletter #2094, *David Handler & the Estate Trust Revival: Maximizing Full Basis Step-Up* (April 30, 2013)*.* [↑](#footnote-ref-235)
235. Treas. Reg. §25.2511-2(b). [↑](#footnote-ref-236)
236. Treas. Reg. §25.2511-2(d). [↑](#footnote-ref-237)
237. IRC §2038 is broader than garden variety revocable living trusts: “To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money’s worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to **any change** **through the exercise of a power** (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), **to alter**, **amend**, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent’s death. Treas. Reg. §20.2038(a)-1 also makes it clear that mere veto power over distributions or the ability to affect timing can trigger §2038, even if the ultimate gift may be complete: “Section 2038 is applicable to any power affecting the time or manner of enjoyment of property or its income, even though the identity of the beneficiary is not affected. For example, Section 2038 is applicable to a power reserved by the grantor of a trust to accumulate income or distribute it to A, and to distribute corpus to A, even though the remainder is vested in A or his estate, and no other person has any beneficial interest in the trust.” [↑](#footnote-ref-238)
238. IRC §2523(f)(5)(A)(i) “such property shall not be includible in the gross estate of the donor spouse”. Intervivos marital trusts granting a spouse a GPOA rather than QTIP have a similar clause in §2523(e)(2). [↑](#footnote-ref-239)
239. IRS Technical Advice Memorandum (TAM) 2009-07025. [↑](#footnote-ref-240)
240. Portions of this section were published in *The Upstream Crummey Optimal Basis Increase Trust*, May 2014 issue of CCH Estate Planning Review. [↑](#footnote-ref-241)
241. *Dickman v. Commisioner*, 465 US 330, 338 (1984) [↑](#footnote-ref-242)
242. This technique could certainly be done with other non-depreciable property or use continuing annual *Crummey* gifts, but this article will keep the example stark and simple in order to more easily follow the concepts. [↑](#footnote-ref-243)
243. Rev. Rul. 85-13, 1985-1 CB 184, most recently followed by IRS in CCA 2013-43021. Also, Rev. Rul. 2007-13 [↑](#footnote-ref-244)
244. The appointive assets subject to the power would typically be capped to the powerholder’s available applicable exclusion amount, or to the available state estate tax exemption. [↑](#footnote-ref-245)
245. *Crane v. Commissioner*, 331 U.S. 1 (1947). See also [*Tufts v. Comm.*, 461 U.S. 300](https://supreme.justia.com/cases/federal/us/461/300/case.html) (1983). [↑](#footnote-ref-246)
246. IRC §2053. [↑](#footnote-ref-247)
247. Treas. Reg. §20.2053-7. [↑](#footnote-ref-248)
248. See Uniform Commercial Code §8, §9 and good short articles from the law firms of Carlisle, Patchen and Murphy and Spencer Fane on UCC filing differences between securing stock and LLC/LP interests, see <http://www.cpmlaw.com/NewsDetail/LLC-and-LP-interests> and <http://www.spencerfane.com/Perfecting-a-Security-Interest-in-a-Limited-Liability-Company-Ownership-Interest--Not-a-Simple-Task-02-06-2013/>. [↑](#footnote-ref-249)
249. Treas. Reg. §1.742-1. [↑](#footnote-ref-250)
250. IRC §1014(f) added by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015. [↑](#footnote-ref-251)
251. Prop. Treas. Reg. §1.1014-10(e), Example 4, available at <https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-04718.pdf>. [↑](#footnote-ref-252)
252. Prop. Treas. Reg. §1.1014-10(e), Example 1, available at <https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-04718.pdf>. [↑](#footnote-ref-253)
253. Prop. Treas. Reg. §1.1014-10(a)(2), available at <https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-04718.pdf>. [↑](#footnote-ref-254)
254. A “tontine” is an annuity, insurance or trust arrangement wherein all the benefits go to the last survivor of the pool. They were quite common hundreds of years ago but more likely encountered by readers today in novels or in episodes of M\*A\*S\*H or The Simpsons. I do not know if there is a historical precedent for a “reverse” tontine where the first beneficiary-to-die’s estate receives (or at least potentially controls) the spoils rather than the last survivor’s, but that is the concept here. [↑](#footnote-ref-255)
255. Or, maybe not, see discussion in section above concerning the Use of Intervivos QTIP Trusts to avoid §1014(e) – many of the same arguments in that section could equally apply here. [↑](#footnote-ref-256)
256. See Part V, and more recent LISI Estate Planning Newsletter #2192, *Jeff Scroggin: Understanding Section 1014(e) & Tax Basis Planning,* and *LISI Estate Planning Newsletter #2194, Jeff Scroggin & Michael Burns on Tax Basis Planning: The Basics, LISI Estate Planning Newsletter #2203, Alan Gassman, Christopher Denicolo and Ed Morrow Response to Jeff Scroggin’s Commentary.* [↑](#footnote-ref-257)
257. Treas. Reg. §1.1001-2, ex. 5. [↑](#footnote-ref-258)
258. To mitigate against that event, John might purchase life insurance and of course, if John becomes terminally ill or death is not sudden, he or his agent under a power of attorney would repurchase the assets before his death and cancel the note, substituting cash or even better, assets otherwise destined to be in his estate with higher basis than fair market value. But the odds of John suddenly dying before the other three without warning are extremely slim. [↑](#footnote-ref-259)
259. This ability should not compromise the asset protection or completed gift status of the initial gift. [↑](#footnote-ref-260)
260. Provided John and Jane are still married, this does not necessarily cancel the note or transaction for state property law, but Code Sec. 1041 expressly ignores sales/exchanges between spouses, which would of course include grantor trusts as to spouses as well, per Rev. Rul. 85-13. IRC §1041 is not exactly the same as Rev. Rul. 85-13, however – the sale/exchange is ignored, but not necessarily the interest payments. See *Gibbs v. Commissioner*, T.C. Memo 1997-196 (T.C. 1997). However, this could very easily be fixed by later gift or sale. [↑](#footnote-ref-261)
261. See Reg. §1.671-2(e):

     (1) For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly ***or indirectly*** makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust. \*\*\*\*\*\*\*\*

     **(2)** **(i)** A gratuitous transfer is any transfer other than a transfer for fair market value.

     \*\*\*\*

     (5) If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a ***general*** power of appointment over the transferor trust **exercises** that power in favor of another trust, *then such person will be treated as the grantor of the transferee trust*, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.

     \*\*\*\*

     **Example 9.**

     G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2. [↑](#footnote-ref-262)
262. Reg. §1.671-2(e)(5), above. [↑](#footnote-ref-263)
263. *Restat. 3d of Trusts*, § 58, Comment f. [↑](#footnote-ref-264)
264. See extensive state by state chart in the appendix outlining state law creditor protection aspects of lapses of general powers of appointment (withdrawal), including citations to common law. [↑](#footnote-ref-265)
265. Many states, such as Maine, tax based in large part on the residency of the settlor. Since the exercise of a GPOA (unlike an LPOA) would likely create a new Settlor/grantor for state trust and tax law as well as federal tax law, if the powerholder is a resident of another state this may help avoid state income taxes, or even, in the case of New York, where the powerholder was a resident, since NY’s anti-DING legislation would no longer apply. To examine whether exercise the testamentary general power of appointment is beneficial requires examination of state income tax law of the settlor, power holder as well as the intended remainder/appointee beneficiaries. [↑](#footnote-ref-266)
266. Madorin v. Commissioner, 84 T.C. 667 (1985); Treas. Reg. § 1.1001-2(c), Ex. (5); Rev. Rul. 77-402. Each of these authorities involves debt relief as consideration paid. [↑](#footnote-ref-267)
267. Rev. Rul. 85-13, 1985-1 CB 184. Rev. Rul. 2007-13 [↑](#footnote-ref-268)
268. PLR 9109027, citing *Post v. Commissioner*, 26 T.C. 1055 (T.C. 1956) and §1015 regulations for the proposition that §1015 basis rules regarding gifts still apply even though the initial donor and donee were initially the same taxpayer for income tax purposes (a grantor trust). However, the PLR did not rule on whether the basis was increased by gift tax paid *immediately*, since it was only asked to rule on basis increase in the eventual hands of the remaindermen after grantor trust status ended (which it did approve). It implied that the basis should increase immediately after the gift by declaring (citing *Post*) that the date of the gift for ***income*** tax purposes to be the creation of the trust rather than the later vesting in remaindermen (despite the fact that the taxpayer did not change until then for income tax purposes). However, the ruling stopped short of so declaring. [↑](#footnote-ref-269)
269. Code Sec. 1014(b)(9): “In the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise ***or non-exercise*** of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent’s gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939. In such case, if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent.” See also Treas. Reg. §1.1014-2(a)(4). Treas. Reg. §1.1014-2(b), Treas. Reg. §1.1014-6(a)(3). [↑](#footnote-ref-270)
270. Treas. Reg. §1.1014-6(a)(1). [↑](#footnote-ref-271)
271. Code Sec. 1014(b)(4)**:** “Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;”. There is no reduction for prior depreciation as in (b)(9). [↑](#footnote-ref-272)
272. If a power holder simply appoints to the exact same party that would have taken by default in absence of appointment, the appointment is deemed not to have been exercised and the assets pass by default. See Restatement Third of Property, Donative Transfers, §19.26, also Uniform Power of Appointment Act, §313. [↑](#footnote-ref-273)
273. Testamentary general powers may or may not be subject to a powerholder’s estate’s creditors. Contrary to a popular myth, third-party created testamentary GPOAs and LPOAs are generally ***not*** subject to state statutory share laws. See Uniform Probate Code §2-201, §2-205(1)(A), Fla. Stat. 732.2045, *Bongaards v. Millen,* 793 N.E.2d 335 (Sup. Ct. Mass. 2003). [↑](#footnote-ref-274)
274. Treas. Reg. § 1.170A-6(c)(2), Treas. Reg. § 20.2055-2(e)(2)(vi)(a). [↑](#footnote-ref-275)
275. The First Circuit overruled a lower court and held that such a scenario did ***not*** create deemed control/grantor status as to the father who was the original transferor to a trust for child, where child later transferred the same funds to a new trust with father as beneficiary in *Plimpton v. Commissioner*, 135 F.2d 482 (1st Cir. 1943). [↑](#footnote-ref-276)
276. *Christopher C. Close, et ux. v. Commissioner*, TC Memo 2014-25. For other cases and discussion of when third party created spendthrift trusts can be busted or disregarded by the IRS or other creditors, see *Ed Morrow: Asset Protection Dangers When a Beneficiary Is Sole Trustee and Piercing the Third Party, Beneficiary-Controlled, Irrevocable Trust*, Steve Leimberg's Asset Protection Planning Newsletter #339 (March 9, 2017). [↑](#footnote-ref-277)
277. Most of these cases involve same day, preplanned transfers – consider this excerpt from *Pierre v. Comm'r*, T.C. Memo 2010-106, in which the tax court applied the step transaction doctrine: “It is appropriate to use the step transaction doctrine where the only reason that a single transaction was done as two or more separate transactions was to avoid gift tax. *Estate of Cidulka v. Commissioner,* T.C. Memo 1996-149 (collapsing decedent's transfer to family members of minority interests in closely held stock with his same-day sale/redemption of his remaining stock in the corporation in exchange for a note). We have applied the step transaction doctrine to aggregate a taxpayer's two separate same-day transfers to a partnership of undivided 50-percent interests in land to reflect the economic substance of the transaction. See *Shepherd v. Commissioner*, 115 T.C. 376, 389 (2000), affd. 283 F.3d 1258 (11th Cir. 2002). We have also collapsed a taxpayer's separate same-day steps of funding a partnership with the taxpayer's gifts of partnership interests where, at best, the transactions were integrated and, in effect, simultaneous. *Senda v. Commissioner*, T.C. Memo 2004-160, *aff’d*. 433 F.3d 1044 (8th Cir. 2006).

     Whether several transactions should be considered integrated steps of a single transaction is a question of fact. *Senda v. Commissioner*, 433 F.3d at 1048. We therefore turn to the facts. The transfers at issue all occurred on the same day. Moreover, virtually no time elapsed between the transfers. Petitioner gave away her entire interest in Pierre LLC within the time it took for four documents to be signed.” [↑](#footnote-ref-278)
278. E.g., *T. H. Holman Jr. v. Comm’r.*, 601 F.3d 763, 770, 772 (8th Cir. 2010). [↑](#footnote-ref-279)
279. *Summa Holdings, Inc. v. Comm'r*, 2017 U.S. App. LEXIS 2713 (6th Cir. Feb. 16, 2017). Leimberg Information Services had three articles on the case: *Michael Geeraerts, Paul Vecchione & Jim Magner on Summa Holdings v. Commissioner: IRS Often Argues Substance-Over-Form, But Sometimes Form Is Substance,* LISI Employee Benefits & Retirement Planning Newsletter #670 (March 16, 2017); *Ed Morrow on Summa Holdings Inc. v. Commissioner: 6th Circuit Properly Rejects IRS and Tax Court Substance Over Form Attack on IRAs Owning IC-DISCs, But the IRS Missed the Prohibited Transactions*, LISI Employee Benefits & Retirement Planning Newsletter #672 (March 23, 2017); *Peter Melcher & Grant Keebler on Summa Holdings v. Commissioner*, LISI Employee Benefits & Retirement Planning Newsletter #673 (March 30, 2017). [↑](#footnote-ref-280)
280. Treas. Reg. §25.2523(f)- 1(f), Example 11, which provides that assets held in an inter vivos QTIP trust for the benefit of the settlor after the death of his or her spouse will not be includible in the settlor’s taxable estate under IRC §§2036 or 2038. The regulation does *not* speak to §2041, hence the statutory fixes discussed in FN 38. [↑](#footnote-ref-281)
281. For example, the Fifth Circuit approved disclaimers by **29** devisees of Louise Monroe, some of whom were unrelated to her, made at the request of her husband's nephew. The disclaimers caused the disclaimed property to pass to the decedent's husband free of estate tax. Shortly thereafter, the husband made generous gifts to each of the disclaimants, in many cases equal to the amount disclaimed. The Tax Court had found that the disclaimers were unqualified because they were the result of an implied promise by the husband to make gifts to the devisees if they disclaimed. However, the Court of Appeals for the Fifth Circuit reversed that decision, stating that the very purpose of disclaimers is "to facilitate post-mortem estate tax planning and to increase family wealth on the `expectation' that there will thus remain more wealth to pass on to the disclaimants in the future." *Estate of Monroe v. C.L.R.*, 124 F3d 699 (5th Cir 1997). [↑](#footnote-ref-282)
282. *Estate of Steve K. Backemeyer v. Comm'r*, 2016 U.S. Tax Ct. LEXIS 35 (T.C. 2016), 147 T.C. No. 17. [↑](#footnote-ref-283)
283. This is discussed in *It’s Just a JEST – the Joint Exempt Step Up Trust*, LISI Estate Planning Newsletter #2086 (April 3, 2013), by Gassman, Ellwanger and Hohnadell [↑](#footnote-ref-284)
284. IRC §2523 (lifetime marital gift tax deduction), IRC §2503(b) (annual present interest exclusion from gift tax) – as will be discussed, there is no reason lifetime applicable exclusion amount cannot be used as well. [↑](#footnote-ref-285)
285. Treas. Reg. §25.2511-2, Cessation of Donor’s Dominion and Control. [↑](#footnote-ref-286)
286. CCA 2012-08026, in spite of a seemingly contrary treasury regulation at Treas. Reg. §25.2511-2(b). [↑](#footnote-ref-287)
287. It would not cause inclusion under §2041, since a settlor/donor cannot create a general power in him/herself. IRC §2036 generally requires an interest be “retained” whereas a time gap is irrelevant to §2038 if the power exists at death: “(without regard to when or from what source the decedent acquired such power)”. For a case showing partial §2036 inclusion when the power of control was only over a portion (over only 80% rather than 100%, causing 80% inclusion), see *Joy v. United States*, 272 F. Supp. 544 (E.D. Mich. 1967). Thus, these string provisions are not all or nothing. [↑](#footnote-ref-288)
288. See Treas. Reg. §20.2038-1(a). [↑](#footnote-ref-289)
289. Internal Revenue Bulletin 2008-35 (of course, it could be 100% inclusion, it depends on prior rate of return, change in 7520; i.e., how much is needed to pay the remaining annuity) [↑](#footnote-ref-290)
290. Subject, of course, to the three-year rule of IRC §2035. [↑](#footnote-ref-291)
291. Treas. Reg. §20.2038(a)-1 – see further discussion in Part V.f. [↑](#footnote-ref-292)
292. Treas. Reg. §25.2511-2; contrast paragraphs (b) “complete”, with (d) “incomplete” – embrace (d), avoid (b). For a case where grantor/trustee’s retained ability to withhold or distribute income caused estate inclusion, see *United States v. O'Malley*, 383 U.S. 627 (U.S. 1966), finding the predecessor to §2036(a)(2) was triggered. [↑](#footnote-ref-293)
293. IRC §2503(b). [↑](#footnote-ref-294)
294. PLR 8727031. It’s crystal clear from the regulations that even if an income/right to use property is only retained for a term of years, it still causes *full inclusion*, see Treas. Reg. 20.2036-1(c)(1)(ii), Examples 1 and 2. [↑](#footnote-ref-295)
295. IRC § 1014(b)(6). [↑](#footnote-ref-296)
296. IRC § 2040(b). [↑](#footnote-ref-297)
297. IRC § 1015(a). [↑](#footnote-ref-298)
298. Or more, or perhaps even less, see *Jerry Hesch, Dick Oshins & Jim Magner: Note Sales, Economic Substance and "The 10% Myth",* LISI Estate Planning Newsletter #2412 (May 9, 2016). [↑](#footnote-ref-299)
299. *In re Huber*, 2013 Bankr. LEXIS 2038 (May 13, 2013), and 11 U.S.C. §548(e) which creates 10-year lookback for fraudulent transfers to self-settled trusts or similar devices. [↑](#footnote-ref-300)
300. See PLR 9837007, PLR 2009-44002. [↑](#footnote-ref-301)
301. Tied to the 5% or $5,000 lapse protection of IRC §2514(e). Advocates of BDITs contend that minimal seeding can be overcome with loan guarantees to enable larger transactions despite smaller seed gifts. [↑](#footnote-ref-302)
302. Treas. Reg. §20.2038-1(a)(2). [↑](#footnote-ref-303)
303. 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 and various hybrids. [↑](#footnote-ref-304)
304. 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”. [↑](#footnote-ref-305)
305. 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). [↑](#footnote-ref-306)
306. Ohio R.C. §5816.01 et seq., this and others are commonly known as domestic asset protection trust statutes. [↑](#footnote-ref-307)
307. Arizona may be an exception. See Ariz. Rev. Stat. 14-10505(E)(3). [↑](#footnote-ref-308)
308. See footnote 37 for further discussion, explanation and list of state statutes addressing this issue. [↑](#footnote-ref-309)
309. Treas. Reg. §1.671-2(e)(6), Example 9 – thanks to attorney Gary Maddox for correcting a typo and suggesting clarifications to this discussion. [↑](#footnote-ref-310)
310. Treas. Reg. §1.671-2(e)(5). [↑](#footnote-ref-311)
311. 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 specific language of the regulation, W did NOT exercise her GPOA. [↑](#footnote-ref-312)
312. 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. Of course, parties can still carve an agreement and then get a court to bless it. [↑](#footnote-ref-313)
313. *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. For one of several cases denying the marital deduction for attempts at a post-mortem “fix” despite marital savings clauses, see *Estate of Rapp*, 130 F.3d 1211 (9th Cir. 1998). [↑](#footnote-ref-314)
314. 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). The trend is not favorable. In PLR 2016-28004, PLR 2016-28005 and PLR 2016-28006, the IRS refused to give retroactive effect to a state court reformation of a decedent's IRA beneficiary designation, and insisted that the decedent's three children calculate their RMDs based on the decedent's remaining life expectancy on the date of his death. [↑](#footnote-ref-315)
315. “[N]ot even judicial reformation can operate to change the federal tax consequences of a completed transaction." *American Nurseryman Pub. v. Comm*., 75 T.C. 271 (1980), citing a string of cases holding similarly from various circuits. [↑](#footnote-ref-316)
316. Rev. Rul. 73-142. [↑](#footnote-ref-317)
317. Treas. Reg. §20.2041-1(b)(1), Rev. Rul. 95-58. [↑](#footnote-ref-318)
318. PLR 2005-43037. [↑](#footnote-ref-319)
319. For example, a taxpayer successfully reformed an irrevocable trust after the document was drafted and transfer made in order to qualify for annual exclusion, but any retroactive gift tax effect of the reformation was denied: *Van Den Wymelenberg v. United States*, 397 F.2d 443 (7th Cir. Wis. 1968) [↑](#footnote-ref-320)
320. Rev. Proc. 94-44, interpreting the effect of Florida’s savings statute that engrafted ascertainable standards onto a beneficiary/trustee to prevent the beneficiary/trustee from holding a general power of appointment. This is probably now the law in most states, see Uniform Trust Code §814(b). [↑](#footnote-ref-321)
321. IRC §2514 [↑](#footnote-ref-322)
322. PLR 2011-32017, see also PLR 2010-06005 approving reform of a GPOA to an LPOA w/o adverse tax effect. [↑](#footnote-ref-323)
323. PLR 2018-45006. For a short one-page article on that PLR, see <https://www.linkedin.com/pulse/new-plr-sanctions-amending-irrev-trust-testamentary-edwin-morrow-iii/> [↑](#footnote-ref-324)
324. PLR 9805025. [↑](#footnote-ref-325)
325. For a great summary of the more than 20 various decanting statutes and their various characteristics, see <http://www.sidley.com/state-decanting-statutes/>. See further discussion of decanting specifically in paragraphs h and i of this section. [↑](#footnote-ref-326)
326. Uniform Trust Code §411(b). [↑](#footnote-ref-327)
327. Uniform Trust Code §411(a). [↑](#footnote-ref-328)
328. 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. [↑](#footnote-ref-329)
329. Rev. Rul. 81-264, also GCM 38584. [↑](#footnote-ref-330)
330. Rev. Rul. 84-105. A later ruling is similar: in Rev. Rul. 86-39, a beneficiary of a trust acquiesced in a recapitalization and funding of a trust split that essentially had the effect of shifting more value to the trust over which the beneficiary did not have a testamentary general power of appointment and away from the trust over which he did have a testamentary general power of appointment. The IRS ruled that this would be a taxable gift: “S, as the beneficiary of Trust A, could have asserted the right of a trust beneficiary under local law to prevent the trustee from permitting a loss in value of the trust assets. The execution of the release in which S agreed not to raise an objection to the trustee's conduct with respect to the recapitalization constitutes a release of a general testamentary power of appointment by S over stock worth 70x dollars. For purposes of the gift tax, the release by S is treated as a transfer of property to C, the owner of the remainder interest in Trust B, for which S did not receive adequate and full consideration. See Rev. Rul. 84-105.” [↑](#footnote-ref-331)
331. *Sexton v. U.S.*, 300 F.2d 490 (7th Cir. 1962), *cert denied* 371 U.S. 820 (1962). [↑](#footnote-ref-332)
332. *Brooks v. Welch*, 29 F.Supp. 819 (D. Mass. 1938). [↑](#footnote-ref-333)
333. PLR 2011-22007, see also similar PLR 8535020. [↑](#footnote-ref-334)
334. In addition to PLRs above, Rev. Rul. 67-370, Rev. Rul. 75-550 and PLR 8824025, PLR 8905035, PLR 9451049 (support), PLR 9714030, PLR 9802031, PLR 9811044, PLR 1999-08060, PLR 2002-43026, PLR 2003-39021, PLR 2007-45015, PLR 2007-45016, PLR 2001-22007, PLR 2013-42001 (list copied from fn38 of *The Dueling Transferors Problem in Generation Skipping Transfer Taxation*, ACTEC Law Journal Volume 41 Number 1 Spring 2015, by Austin Bramwell and Sean R. Weissbart). [↑](#footnote-ref-335)
335. IRS TAM 9419007, citing *Jewett v. Comm'r*, 455 U.S. 305 (U.S. 1982), the TAM discussing the exercise of a limited power of appointment that essentially eliminated a power holder’s vested contingent remainder interest, and the *Jewett* case discussing a non-qualified disclaimer’s elimination of the same. [↑](#footnote-ref-336)
336. PLR 9451049, citing Rev. Rul. 75-550 for how to value such interests – just because a discretionary HEMS interest is not in one’s estate for federal tax purposes per §2041, nor subject to creditors under most state laws, does not mean that it has no value as a property right! Not only is this true in the gift context, but also for tax liens on trust interests, see separate outline by author. [↑](#footnote-ref-337)
337. Treas. Reg. §25.2511-1(c)(1), quoted in full above. [↑](#footnote-ref-338)
338. See [PLR 2005-36018](https://www.irs.gov/pub/irs-wd/0536018.pdf) (pages 5-6 discuss gift tax aspects), in which the IRS determined that a court-ordered modification of remainder interests whereby children and grandchildren gave up some interest in the trust favor of their children/grandchildren was a taxable gift. [↑](#footnote-ref-339)
339. See *Gifts by Fiduciaries by Tax Options and Elections,* cited and discussed on page 33, footnote 75. But, recall the beneficiary/spouse/trustee in PLR 9805025 and PLR 2011-32017 initiated the reformations to no ill effect. [↑](#footnote-ref-340)
340. E.g., Uniform Trust Code §412, §416. [↑](#footnote-ref-341)
341. See *DiMarco v. Comm*., 87 T.C. 653 (1986), holding that no gift occurred merely due to acts of a decedent’s employer beyond his control pertaining to involuntarily granted survivor benefits later payable to his spouse. [↑](#footnote-ref-342)
342. Rev. Proc. 94-44. [↑](#footnote-ref-343)
343. *Estate of Victoria E. Dieringer v. Commissioner*, 146 T.C. No. 8 (March 30, 2016), *Atkinson v. Commissioner*, 309 F.3d 129 (11th Cir. 2002) and CCA 2006-28026. This may extend to QSSTs and see-through IRA trusts too. [↑](#footnote-ref-344)
344. See prior discussion (fn 281) on the *Backemeyer* case and the tax benefit rule. I have no idea if the tax benefit rule has ever been applied to estate tax, but certainly the IRS would try any equitable argument in the arsenal to go after such planning and I suspect the tax court would be receptive to any such argument. That said, the recent *Summa Holdings* cases should buoy some spirits – the 6th Circuit (later backed up by the First and Second Circuits in appeals of same case by different parties) slammed the tax court’s broad application of “substance over form”. [↑](#footnote-ref-345)
345. For discussion of fraudulent transfer issues using decanting see *Ferri v. Powell-Ferri: Asset Protection Issues, Perils and Opportunities with Decanting*, Ed Morrow & Steve Oshins, LISI Asset Protection Newsletter #240. A disgruntled spouse tried to void a trustee’s decanting that removed the husband/beneficiary’s withdrawal right just prior to divorce as fraudulent but was denied relief. This case had a long, interesting history with multiple issues. [↑](#footnote-ref-346)
346. *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 dilute or destroy asset protection, see author’s separate CLE outlines. [↑](#footnote-ref-347)
347. See discussion in the Uniform Disclaimer of Property Interests Act, §§6-7. [↑](#footnote-ref-348)
348. Treas. Reg. §26.2601-1(b)(4)(i)(D). [↑](#footnote-ref-349)
349. *Cottage Savings Association v. Commissioner,* 499 U.S. 554 (1991). [↑](#footnote-ref-350)
350. *Evans v. Commissioner*, 30 T.C. 798 (1958). [↑](#footnote-ref-351)
351. Rev. Rul. 73-476, Rev. Rul. 79-44. However, if it’s only one parcel being divided pursuant to state law partition, see Rev. Rul. 56-437 and another more recent ruling holding that no exchange occurs, PLR 2004-11022. [↑](#footnote-ref-352)
352. *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969). [↑](#footnote-ref-353)
353. PLR 2002-31011. [↑](#footnote-ref-354)
354. IRC §1001(a), Treas. Reg. §1.1001-1(a). [↑](#footnote-ref-355)
355. PLR 2008-04015 (splitting into subtrusts), PLR 2007-36023, PLR 2007-28026, PLR 2007-25008, PLR 2007-17007, PLR 2006-45005, PLR 2010-42004, PLR 2010-33025, PLR 2010-21004, PLR 2010-23004, PLR 2007-42011, PLR 2007-36023, PLR 2007-28026, PLR 2006-47022, PLR 2006-37042, PLR 2006-33012, PLR 2006-29021, PLR 2006-27008, PLR 2006-19001, PLR 2006-18003, which all concerned various minor modifications and divisions of trusts, but nothing so drastic as 2002-31011. There are probably more than cited above. [↑](#footnote-ref-356)
356. PLR 2010-42004. [↑](#footnote-ref-357)
357. Treas. Reg. §1.1002-1(d). [↑](#footnote-ref-358)
358. E.g. UTC §411-§417. [↑](#footnote-ref-359)
359. Treas. Reg. §1.1001-1(h). [↑](#footnote-ref-360)
360. Although there is no definition in IRC §1001, Treas. Reg. 26.2642-6(b) and (d) provide a definition in the GST context and set out seven requirements, summarized as pursuant to instrument or state law, effective under local law, funding done within 90 days of selected valuation date, fractional basis division, [↑](#footnote-ref-361)
361. If you are in a UTC state, see Uniform Trust Code §816(22), which adds that power. Comments expressly note why: “Paragraph (22) authorizes a trustee to make non-pro-rata distributions and allocate particular assets in proportionate or disproportionate shares. This power provides needed flexibility and *lessens the risk that a non-pro-rata distribution will be treated as a taxable sale*.” [↑](#footnote-ref-362)
362. PLR 9352005. [↑](#footnote-ref-363)
363. PLR 2013-20004, modifications complying with GST grandfathering regs were OK for *allocated* GST exempt [↑](#footnote-ref-364)
364. PLR 2016-47001. [↑](#footnote-ref-365)
365. *Getty v. Commissioner*, 913 F.2d 1486, 1488 (9th Cir. 1990). [↑](#footnote-ref-366)
366. IRC §101(a)(2). [↑](#footnote-ref-367)
367. IRC §1001(e), with exception at §1001(e)(3) when the trust is terminated (both income and remainder interest), but regulations require this be through sale to a third party, see Treas. Reg. §1.1001-1(f), so this could occur even if the entire trust is terminated. [↑](#footnote-ref-368)
368. Ohio R.C. §5808.18(B). [↑](#footnote-ref-369)
369. 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.” Similarly, for those non-UTC states, see the Restatement (Third) of Property: Wills and Other Donative Transfers § 12.2: “A donative document may be modified, in a manner that does not violate the donor’s probable intention, to achieve the donor’s tax objectives”. [↑](#footnote-ref-370)
370. For example, the holder of a general testamentary power of appointment might be able to virtually represent the takers in default, but in most states the holder of a broad testamentary limited power of appointment cannot. See UTC § 302 or Ohio R.C. §5803.02 for an example. Ohio recently amended this statute to permit the holder of a broad *limited* power of appointment to have the same power. Ohio H.B. 432 signed into law January 4, 2017. [↑](#footnote-ref-371)
371. Rev. Proc. 2017-3 §5.01(9), (14),(15). [↑](#footnote-ref-372)
372. *Matter of Johnson*, 2015 N.Y. Misc. LEXIS 51 (N.Y. Sur. Ct. Jan. 13, 2015). [↑](#footnote-ref-373)
373. Ohio R.C. §5808.18(A)(3). [↑](#footnote-ref-374)
374. IRS Notice 2011-101. [↑](#footnote-ref-375)
375. *Kroll v. N.Y. State Dep't of Health*, 2016 NY Slip Op 6499 (N.Y. App. Div., 2016). [↑](#footnote-ref-376)
376. E.g. N.Y. Estates Powers and Trusts Law § 7-2.4. Act of trustee in contravention of trust. If the trust is expressed in the instrument creating the estate of the trustee, every sale, conveyance or other act of the trustee in contravention of the trust, except as authorized by this article and by any other provision of law, is void. [↑](#footnote-ref-377)
377. Such was the case in Rev. Rul. 69-486, discussed later herein in footnote 343, where the trustee divided and terminated a trust non-pro rata without explicit authorization in trust nor state statute, triggering gains. Might such self-help terminations done without explicit authorization in the trust instrument nor under state statute be treated similarly? Could this still apply in terminations where only one party is receiving the assets, or only where assets are divided? [↑](#footnote-ref-378)
378. *Estate of Lillian L. Halpern v. Commissioner*, T.C. Memo. 1995-352 (ultra vires distributions from marital trust brought back into trust, hence back into surviving spouse’s estate). [↑](#footnote-ref-379)
379. See, e.g., the string of cases cited in *American Nurseryman Pub. v. Comm*., 75 T.C. 271 (1980). [↑](#footnote-ref-380)
380. See Uniform Trust Code §§301-305 for when parties may bind minor/incapacitated or unborn beneficiaries. [↑](#footnote-ref-381)
381. IRC § 1411(c)(1). [↑](#footnote-ref-382)
382. IRC §1411(c)(2),(4),(5),(6). [↑](#footnote-ref-383)
383. 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. Reg. §1.1411-3(b)(1)(iii). This article will omit discussion of estates, since they usually present less of a problem, due to recent step up in basis, higher than usual administrative deductions, and the fact that terminating estates pass out capital gains as part of DNI. [↑](#footnote-ref-384)
384. 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. [↑](#footnote-ref-385)
385. Short term capital gains passed through from mutual funds (phantom gains) may be allocated to accounting income rather than principal – see Uniform Principal and Income Act, §401. [↑](#footnote-ref-386)
386. IRC §643(a)(3), Treas. Reg. §1.643(a)-3(a). Capital gains are generally excluded from DNI, but recapture income due to prior depreciation on sale may be included, see 1995 FSA LEXIS 551 (I.R.S. 1995). [↑](#footnote-ref-387)
387. For rules on how the surtax applies subchapter J principals to trusts, see Treas. Reg. §1.1411-3. Bracket adjusts for inflation. [↑](#footnote-ref-388)
388. AMT of 26%/28% rates could also applicable to trusts, which have lower exemption amount – see IRC §55-56. [↑](#footnote-ref-389)
389. As to state income tax, trusts may pay tax in multiple states, or *avoid* all state income tax, depending on the circumstance – see Section VIII.n. on Incomplete Gift Non-Grantor Trusts, which discusses state trust income tax. [↑](#footnote-ref-390)
390. 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. [↑](#footnote-ref-391)
391. As of September 2017, the following sections on §678 have been reorganized, updated and improved into a separate article for Leimberg Information Services Estate Planning Newsletter, with a white paper uploaded to www.ssrn.com, see Morrow, Edwin P., *IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)*, <https://ssrn.com/abstract=3165592>. Please see that white paper for updated material on this topic. [↑](#footnote-ref-392)
392. In Subchapter J, Subparts A-D, IRC §641-669, control most traditional trust tax accounting, Subpart E is the grantor trust rules, §671-679. [↑](#footnote-ref-393)
393. *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 into IRC § 678 in 1954, discussed later in this section. [↑](#footnote-ref-394)
394. 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 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. [↑](#footnote-ref-395)
395. 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. [↑](#footnote-ref-396)
396. 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). [↑](#footnote-ref-397)
397. See Uniform Principal and Income Act, §409, §404 [↑](#footnote-ref-398)
398. Treas. Reg. §1.671-3(b)(2) [↑](#footnote-ref-399)
399. 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 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 the power holders). [↑](#footnote-ref-400)
400. Treas. Reg. §1.671-2 Applicable Principals. [↑](#footnote-ref-401)
401. § 1.643(b)-1 “Definition of income. For purposes of **subparts A through D**, part I, subchapter J, chapter 1 of the Internal Revenue Code, **“income,”** when not preceded by the words “taxable,” “distributable net,” “undistributed net,” or “gross,” **means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law**. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.\*\*\*\* [↑](#footnote-ref-402)
402. *Grant v. Commissioner*, 174 F.2d 891 (5th Cir. 1949). Although, §678(d) does provide that “Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.” – slightly different from qualified disclaimer rules. [↑](#footnote-ref-403)
403. Generally GPOAs are unaffected by a powerholder’s incapacity, see various cases cited in footnote 74. IRC §678(a) should follow – see Rev. Rul. 81-6, holding that a minor beneficiary is deemed owner for §678 even if local law requires court appointed guardian and none has yet been appointed. [↑](#footnote-ref-404)
404. Rev. Rul. 67-241: Widow had a typical 5/5 power (over the greater of $5,000 or 5% of the trust corpus). “Since the widow has a power exercisable solely by herself to vest a portion of the trust corpus in herself, she is treated as the owner of that portion of the trust under section 678 of the Code. As the owner of a portion of the trust corpus, there are included in computing her tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. Pursuant to the provisions of section 1.671-4 of the regulations, these items should not be reported by the trust on Form 1041, U.S. Fiduciary Income Tax Return (for estates, and trusts), but should be shown on a separate statement to be attached to that form. The portions of trust corpus considered owned by the widow are not subject to the provisions of sections 661(a)(2) and 662(a)(2) of the Code when distributed to her.” [↑](#footnote-ref-405)
405. 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. Also, see Rev. Rul. 67-241 quoted above. [↑](#footnote-ref-406)
406. Generally, distributions of appreciated property in kind to fund a pecuniary amount can trigger taxation known as *Kenan* gain, from *Kenan v. Comm*., 114 F. 2d 217 (2d Cir. 1940). Treas. Reg. §1.1014-4(a)(3). Non-pro rata divisions of even a residuary do the same if there is no trustee authority, pursuant to Rev. Rul. 69-486, but most trusts nowadays should have the power to do this, either through boilerplate or state law. See Uniform Trust Code §816(22). Generally, if a trustee gives $50,000 of stock with a basis of $40,000 to pay a $50,000 obligation (e.g., an annuity), the trust incurs $10,000 gain and the beneficiary has a basis of $50,000. Rev. Rul. 68-392. Surprisingly, this holds true even if the pecuniary is a *de facto* residuary (e.g., “give the first $1 trillion to x”, or more commonly, the applicable exclusion amount or GST exemption amount). See Rev. Rul. 66-207, 1966-2 C.B. 243 (debatable, but that’s the IRS position). However, if this share comes from a grantor trust (even one deemed owned under IRC § 678), no gain should be triggered at all (at least if it’s to the deemed owner). Rev. Rul. 85-13. [↑](#footnote-ref-407)
407. *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). [↑](#footnote-ref-408)
408. *Id*. at 5. [↑](#footnote-ref-409)
409. *Campbell v. Commissioner*, T.C. Memo 1979-495. [↑](#footnote-ref-410)
410. *Id*. at 16. [↑](#footnote-ref-411)
411. PLR 2016-33021. Recall that while PLRs are not precedential and the IRS is never bound by them, they might be helpful as authority in avoiding penalties for substantial understatement of tax. Remember, however, that “An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight.” See [Treas. Reg. §1.6662-4(d)(3)(ii)](https://www.law.cornell.edu/cfr/text/26/1.6662-4), and for a recent case that used a PLR successfully to avoid 20% penalties, see *Plateau Holdings, LLC v. Comm.*, T.C. Memo. 2021-133. [↑](#footnote-ref-412)
412. More accurately, no income to report under Subparts A-D of Subchapter J, but under Subpart E grantor trust. [↑](#footnote-ref-413)
413. 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. [↑](#footnote-ref-414)
414. *Goldsby v. Commissioner*, T.C. Memo 2006-274. [↑](#footnote-ref-415)
415. Arguably, a §678(a) trust should avoid arguments that the trust is not an “agent for a natural person” pursuant to IRC §72(u). See *The Advisor’s Guide to Annuities*, by Michael Kitces and John Olsen. Non-qualified annuities, perhaps even more so than IRAs/Qualified plans, 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. [↑](#footnote-ref-416)
416. 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 corporation – 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 was previously due to expire but was made permanent by §124 of the Protecting Americans from Tax Hikes (PATH) Act of 2015, and will adjust annually for inflation ($510,000 in 2017 per Rev. Proc. 2016-55, § 3.25). [↑](#footnote-ref-417)
417. 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 of course includes §678(a). PLR 2012-16034 recently followed this, ruling that a beneficiary-grantor trust created via *Crummey* power qualifies as an S corporation 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. [↑](#footnote-ref-418)
418. See IRC §1244, Treas. Reg. §1.671-3(a) and (a)(2). [↑](#footnote-ref-419)
419. See *Using Separate or Stand Alone Trusts to Receive Retirement Benefits*, Edwin Morrow, Journal of Retirement Planning, Sept 2007, and ask the author for 2016 update from CLE outline on various income tax advantages of segregating such accounts. [↑](#footnote-ref-420)
420. 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. [↑](#footnote-ref-421)
421. IRC §2514(e). However, the 5% would pertain to the taxable income available to withdraw, not the entire principal from which the withdrawal amount is drawn from, as some authors in this area have assumed – see Rev. Rul. 66-87. If a beneficiary has the right to withdraw $120,000 of taxable income from a $2 million trust corpus, and does not take it, the lapse protection is $6,000 (5% of $120,000), not $100,000 (5% of $2 million). If the $2 million has two equal separate shares with each beneficiary able to withdraw half the same amount above, the amount of a standard 5/5 lapse protection would be $5,000 (the greater of $5,000 or 5% of $60,000), not $50,000, because the “assets out of which” is the $60,000 of withdrawable income, not $1 million. To ensure greater lapse protection and enable more to stay protected in the trust without the beneficiary being deemed the grantor, we need to amend the withdrawal right a bit. For example, if the beneficiary were able to withdraw the greater of the taxable income or 5% of the corpus, the lapse protection would increase accordingly to $100,000 (or $50,000 in our example of the $2 million corpus with two separate shares). The lapse protection may differ for state creditor protection law than federal tax law. In most states, the amount in the above scenario which is protected from being deemed a contribution by the beneficiary as a settlor would be the greater of 5% or the annual exclusion amount (as of 2016, $14,000, or double that, $28,000, depending on whether the original donor was married at the time). Restatement of Trusts, 3d, §56 comment b and UTC § 505(b), which was patterned after Arizona R.S. § 14-7705(g) and Texas P.C. § 112.035(e). Though many UTC states double the annual exclusion lapse protection, as in Ohio R.C. §5805.06(B)(2), a few may omit it altogether (Massachusetts). [↑](#footnote-ref-422)
422. Treas. Reg. §1.671-3(a)(2). [↑](#footnote-ref-423)
423. See Treas. Reg. §1.671-4 for various alternative methods of grantor trust reporting compliance – if the grantor is trustee a Form 1041 filing can be avoided. If a third party is trustee, a Form 1041 is filed with a box checked for grantor trust status and the trustee attaches a statement (not a K-1) showing income, deductions, credits, etc. [↑](#footnote-ref-424)
424. IRC §642(h). [↑](#footnote-ref-425)
425. Treas. Reg. §1.671-3(a). [↑](#footnote-ref-426)
426. Remember, however, the trustee would typically have a parallel discretion to make distributions, so it’s not like the beneficiary/power holder would be unable to receive any distributions in a down year – it depends on how the trust is drafted. The trust could also be drafted to have two parallel withdrawal rights – one over ordinary income/accounting income and a separate one over net capital gains, in which case the w/d right in the above scenario would be $50,000. [↑](#footnote-ref-427)
427. IRC §643(a)(3) for general rule for capital loss/DNI and IRC §642(h) for terminating distributions carrying out loss. [↑](#footnote-ref-428)
428. Treas. Reg. §1.1411-3(b)(1)(v). [↑](#footnote-ref-429)
429. For discussion of fraudulent transfer failures using trust protector/decanting see *Ferri v. Powell-Ferri: Asset Protection Issues, Perils and Opportunities with Decanting*, Ed Morrow & Steve Oshins, LISI Asset Protection Newsletter #240, for efficacy of automatic forfeiture (cessor) clauses, see other CLE materials from author. [↑](#footnote-ref-430)
430. 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, the statute should equally apply if all the capital gains are subject to a withdraw right, as discussed above. This is perfectly consistent with Treas. Reg. §1.671-3(a)(2) and IRC §678(a). [↑](#footnote-ref-431)
431. Treas. Reg. §1.121-1(c)(3): “(i) Trusts. If a residence is owned by a trust, for the period that a taxpayer is treated under sections 671 through 679 (relating to the treatment of grantors and others as substantial owners) as the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the trust will be treated as if made by the taxpayer. See also PLR 1999-12026 (revocable trust eligible – why someone bothered with a PLR for that is unclear). [↑](#footnote-ref-432)
432. PLR 2001-04005 (bypass trust w/ 5% withdrawal power eligible for at least 5% of capital gains exclusion as partial grantor trust, thought the PLR did not discuss the possibility of higher % based on prior lapses/release). This is perfectly consistent with Rev. Rul. 67-241 quoted earlier. [↑](#footnote-ref-433)
433. Since this paper was first written, IRC §68(f) was added to the code to temporarily phase out Pease limitations:

     “(f)Section not to apply

     This section shall not apply to any taxable year beginning after December 31, 2017, and before January 1, 2026.” [↑](#footnote-ref-434)
434. Statistics show that widowers are more likely to remarry much sooner after a death of a spouse than widows. [↑](#footnote-ref-435)
435. See IRC §121(b)(4) and IRC §121(b):

     “**(2) Special rules for joint returns.** In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property—

     **(A) $500,000 Limitation for certain joint returns** Paragraph (1) shall be applied by substituting “$500,000” for “$250,000” if— **(i)** either spouse meets the ownership requirements of subsection (a) with respect to such property;**(ii)** both spouses meet the use requirements of subsection (a) with respect to such property; and

     **(iii)** neither spouse is ineligible for the benefits of subsection (a) with respect to such property by reason of paragraph (3).**\*\*\***

     **(3) Application to only 1 sale or exchange every 2 years**

     Subsection (a) shall not apply to any sale or exchange by the taxpayer if, during the 2-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which subsection (a) applied.” [↑](#footnote-ref-436)
436. Uniform Prudent Investor Act (Restatement of Trusts, 3rd), §181. [↑](#footnote-ref-437)
437. Treas. Reg. § 20.2056(b)-5(f)(4), Treas. Reg. §20.2056(b)-7(h) Example 1**.** [↑](#footnote-ref-438)
438. *Commissioner v. Plant*, 76 F.2d 8 (2nd Cir. 1935); PLR 8341005; *A.I. DuPont Testamentary Trust v. Commissioner*, 574 F.2d 1332 (5th Cir. 1978) and 514 F.2d 917 (5th Cir. 1975). [↑](#footnote-ref-439)
439. Treas. Reg. §1.163-1(b) (equitable ownership sufficient). [↑](#footnote-ref-440)
440. IRC §642(b)(2)(C), tied to personal exemption, $3950 in 2014, rather than $100 for typical complex trusts. [↑](#footnote-ref-441)
441. 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.” [↑](#footnote-ref-442)
442. Exceptions may be necessary for QTIP beneficiaries for IRC §2519 reasons, as discussed in Part VIII.k, or grantor-CLT trust owners, who would have self-dealing issues. [↑](#footnote-ref-443)
443. See Treas. Reg. §1.643(a)-3(a) for this default. [↑](#footnote-ref-444)
444. IRC § 643(a)(3). [↑](#footnote-ref-445)
445. Treas. Reg. §1.643(a)-3(b). [↑](#footnote-ref-446)
446. 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](http://www.law.cornell.edu/uscode/text/26/401) [(a)](http://www.law.cornell.edu/uscode/text/26/usc_sec_26_00000401----000-#a), [403](http://www.law.cornell.edu/uscode/text/26/403) [(a)](http://www.law.cornell.edu/uscode/text/26/usc_sec_26_00000403----000-#a), [403](http://www.law.cornell.edu/uscode/text/26/403) [(b)](http://www.law.cornell.edu/uscode/text/26/usc_sec_26_00000403----000-#b), [408](http://www.law.cornell.edu/uscode/text/26/408), [408A](http://www.law.cornell.edu/uscode/text/26/408A), or [457](http://www.law.cornell.edu/uscode/text/26/457) [(b)](http://www.law.cornell.edu/uscode/text/26/usc_sec_26_00000457----000-#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); [↑](#footnote-ref-447)
447. 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. [↑](#footnote-ref-448)
448. Rev. Rul. 68-392 did not allow capital gains to be included as part of distribution because the trust instrument was silent and local law deemed capital gains to be allocated to corpus – no mention of trustee override possibility. [↑](#footnote-ref-449)
449. 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. [↑](#footnote-ref-450)
450. Drafting Example: “In exercising the trustee’s discretion noted above in making distributions, my trustee may consider any capital gains realized by the trust as a relevant, but not exclusive, factor in determining the extent of any discretionary distribution. It is my intention that this provision comply with Treas. Reg. §1.643(a)-3(b)(3) to permit the trustee to include capital gains in distributable net income.” [↑](#footnote-ref-451)
451. 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”. Treas. Reg. §1.643(b)-1. 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. Some states may add language to their trust code as well as UPIA, e.g. N.C.G.S. § 36C-8-816 added this to their “Specific Powers of Trustees”: (16) “Exercise elections with respect to federal, state, and local taxes including, but not limited to, considering discretionary distributions to a beneficiary as being made from capital gains realized during the year;” [↑](#footnote-ref-452)
452. Uniform Principal and Income Act (UPIA), §§103, 104. [↑](#footnote-ref-453)
453. Drafting 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 who is neither a beneficiary nor “related or subordinate” (as those terms are defined in IRC § 672) to any beneficiary of a trust may reallocate capital gains 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 cause more tax overall than simply grossing up the distribution and allocating capital gains to income to achieve the same after-tax result to the beneficiaries.” [↑](#footnote-ref-454)
454. The top rate for long-term capital gains is now at quite a bit lower level than the top rate for ordinary income, which starts at over $600,000 for married filing jointly. For 2019, compare:

     | **Long Term Capital Gains Tax Brackets for Tax Year 2019, Individuals** | | | |
     | --- | --- | --- | --- |
     | **Tax Bracket/Rate** | **Single** | **Married Filing Jointly** | **Head of Household** |
     | 0% | $0 - $39,375 | $0 - $78,750 | $0 - $52,750 |
     | 15% | $39,376 - $434,550 | $78,751 - $488,850 | $52,751 - $461,700 |
     | 20% | $434,551+ | $488,851+ | $461,701+ |

     | **Long Term Capital Gains Tax Brackets for Tax Year 2019, Trusts and Estates** | | |
     | --- | --- | --- |
     | **Tax Bracket/Rate** | **Single** |
     | **0%** | **$0 - $2,600** |
     | **15%** | **$2,601 - $12,700** |
     | **20%** | **$12,700+** |

     [↑](#footnote-ref-455)
455. 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. [↑](#footnote-ref-456)
456. This should not cause estate inclusion, if it is properly circumscribed with support obligation savings clauseprovision 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, or if the exercising powerholder has a testamentary GPOA over the same asset, as discussed elsewhere herein. IRC §2514(d). It could also trigger a gift of a portion, but probably not the entire amount, if the power holder has a mandatory income or even HEMS rights. See cases and rulings discussed in footnote below. This potential for gift tax effect is a good reason to add a collateral limited power held by a family friend or other non-adverse party, or enable a trust protector to add such a power. [↑](#footnote-ref-457)
457. See IRC §642(c)(1) and Treas. Reg. §1.642(c)-1. 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. While some express some uncertainty on this point from later narrower decisions from lower courts, recent PLRs have followed the Supreme Court and permitted the §642(c) deduction for a distribution pursuant to a lifetime limited power of appointment: PLR 2012-25004 and PLR 2009-06008. If there is no language in the instrument permitting charitable distributions, this would fail to qualify for the §642(c) deduction, see e.g., *Harvey C. Hubbell Trust v. Comm.*, T.C. Summ. Op. 2016-67. See discussion of such nuances in Chapter 6.08 of *Federal Income Taxation of Trusts, Estates and Beneficiaries* by Ascher, Ferguson, Freeland. Does exercise of 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 just as any other trustee distribution to a beneficiary (after all, a powerholder has no control or *custody* of assets, the trustee as legal owner must still make the distribution, only it’s at the power holder’s direction). 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, due to the powerholder’s lost income. Rev. Rul. 79-327, *Estate of Regester*, 83 T.C. 1 (1984), though contrary is *Self v. United States*, 142 F. Supp. 939 (1956). The IRS, in TAM 9419007, has indicated it will follow *Regester* (finding a gift) and **not** *Self*. Valuing the gift may be difficult when it’s not a simply “all net income” trust. In PLR 8535020, a similar lifetime limited power of appointment was exercised in a trust wherein income payments to the powerholder/beneficiary were discretionary. The IRS cited Rev. Rul. 79-327 and stated: “The fact that the trustee has discretion regarding distributions of income and principal to you is **a factor** that must be taken into account in determining the fair market value of your beneficial interest, but, as indicated by Rev. Rul. 67-370, the presence of the possibility of your receiving less than the entire income and principal does not warrant our finding that your transfer of the interest is not subject to the tax imposed by section 2501(a) of the Code.” The IRS had no further guidance on how to value it, other than implying it would be less than if there were a mandatory income interest. 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*. This should avoid any imputed gift, and avoid any fiduciary duties owed to spray beneficiaries. Another way to get around a taxable gift is if the beneficiary is a trustee or co-trustee and uses fiduciary discretion to make distributions pursuant to ascertainable standards – see Treas. Reg. §25.2511-1(g)(2). [↑](#footnote-ref-458)
458. IRA “see through trust” rules don’t play well with most powers of appointment and neither do QSSTs. ESBTs force higher rate taxation regardless of who the distributions are made to (at least for S corp income), so consider segregating those to separate trusts. [↑](#footnote-ref-459)
459. In Rev. Rul. 72-154, the spouse had the lifetime power to appoint principal “for the purpose of providing for the welfare, maintenance, support or education of decedent’s descendants”, and this was deemed not fatal to the marital deduction.

     From TAM 2004-44023, page 8, “In this case, under Paragraph 3(a) of Trust 1, the trustee is to distribute trust income to the Wife, ***or such persons as the Wife directs***, in such amounts as she directs. In addition under Paragraph 10(b), Wife has the right to withdraw all or part of the assets from the trust at any time. As discussed above, in accordance with section 20.2056(b)-5(f)(8), Wife is entitled for life to all trust income, in view of her power to require that all trust assets be distributed to her. Further, the Wife’s discretionary power to direct that trust income be distributed to decedent’s descendants does not change this result [qualification for the marital deduction]. See Rev. Rul. 72-154, cited above.” [↑](#footnote-ref-460)
460. PLR 8943005 permitted the spouse in a QTIP to retain a broad presently exercisable general power of appointment, but Treas. Reg § 20.2056(b)-7(h), Ex. 4, issued later in 1994, failed to clarify this and appears to foreclose any power to appoint to others:

     “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**.” It’s unclear whether the power in this example is a general power or a limited power. Perhaps the IRS would have no objection if it were a *general* power, as in PLR 8943005, but it’s hard to have any confidence in this conclusion despite the underlying common sense logic of the PLR. [↑](#footnote-ref-461)
461. See PLR 9034004 – “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)/BDOT trust is the worst of all worlds. [↑](#footnote-ref-462)
462. Treas. Reg. §1.643(a)-3(b)(2) and (3). Paragraphs (b)(2) and (b)(3) permit capital gains to be part of DNI without having to allocate capital gains to income as paragraph (b)(1) would. [↑](#footnote-ref-463)
463. Treas. Reg. §1.642(c)-1(a)(2): “In determining whether an amount is paid for a purpose specified in section 170(c)(2) the provisions of section 170(c)(2)(A) shall not be taken into account. Thus, an amount paid to a corporation, trust, or community chest, fund, or foundation otherwise described in section 170(c)(2) shall be considered paid for a purpose specified in section 170(c) even though the corporation, trust, or community chest, fund, or foundation is not created or organized in the United States, any State, the District of Columbia, or any possession of the United States.” 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; For the US-Canada treaty, see <http://www.irs.gov/pub/irs-trty/canada.pdf>. [↑](#footnote-ref-464)
464. 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, PLRs 2016-36004 to 2016-36010, which all granted 9100 relief to permit election even after the due date w/extensions had passed. [↑](#footnote-ref-465)
465. Treas. Prop. Reg. §1.1411-3(e)(2) and Treas. Prop. Reg. §1.1411-3(f) Ex. 2. [↑](#footnote-ref-466)
466. IRC §68(e). Since this paper was first written, IRC §68(f) was added to the code to temporarily phase out Pease limitations for “any taxable year beginning after December 31, 2017, and before January 1, 2026.” [↑](#footnote-ref-467)
467. IRC §643(a)(3)(B). [↑](#footnote-ref-468)
468. § 1.642(c)-3 “Adjustments and other special rules for determining unlimited charitable contributions deduction.

     (a) Income in respect of a decedent. For purposes of §§ 1.642(c)-1 and 1.642(c)-2, an amount received by an estate or trust which is includible in its gross income under section 691(a)(1) as income in respect of a decedent shall be included in the gross income of the estate or trust.” See also PLR 2002-21011, but for an exception see CCA 2006-44020, which did not permit deduction for *pecuniary* bequest, because the trust did not “direct or require that the trustee pay the pecuniary legacies from Trust’s gross income.” Remember that separate share rules under IRC §663(c) may not permit simply allocating IRA income to charity remaindermen and non-taxable income/assets to family remaindermen, if the trust is essentially split into separate shares and the document is silent on split. [↑](#footnote-ref-469)
469. E.g., “If some of your itemized deductions have been phased out on your federal return due to federal adjusted gross income limitations, they must also be phased out on your Idaho return.” – Page 8 of Idaho income tax return instructions available at <http://tax.idaho.gov/forms/EIN00046_10-21-2014.pdf>. According to the Institute on Taxation and Economic Policy, twenty-six states generally follow the federal tax rules for itemized deductions (with exception of disallowing deduction for state income taxes paid) - Alabama, Arizona, Arkansas, Colorado, Delaware, Georgia, Idaho, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, South Carolina, Vermont and Virginia. Six jurisdictions follow federal rules, but with substantial further limitations: California, District of Columbia, Hawaii, New York, Utah & Wisconsin. E.g. see California’s additional phase out scheme at <https://www.ftb.ca.gov/forms/2013/13_540.pdf>. Ten states do not allow the federal itemized deductions at all: Connecticut, Illinois, Indiana, Massachusetts, Michigan, New Jersey, Ohio, Pennsylvania, Rhode Island and West Virginia. <http://www.itepnet.org/pdf/pb52itemized.pdf>. [↑](#footnote-ref-470)
470. E.g. Ohio R.C. §5747.01(S), page 5 of instructions for Ohio Form IT-1041, Maine at 36 Me. Rev. Stat. §5163, §5164; with instructions at: [www.maine.gov/revenue/forms/fiduciary/2010/10\_1041ME\_Gen%20Instructions.pdf](http://www.maine.gov/revenue/forms/fiduciary/2010/10_1041ME_Gen%20Instructions.pdf) [↑](#footnote-ref-471)
471. E.g., both Ohio, Illinois and New York would indirectly allow a charitable deduction to a non-grantor trust because they start with taxable income (line 22 of Form 1041), yet Ohio and Illinois do not recognize charitable deductions for individuals at all and New York limits such deductions to individuals to 50% or 25% if income exceeds $1 million or $10 million respectively. See [www.tax.ohio.gov](http://www.tax.ohio.gov), <http://www.tax.ny.gov/pdf/2012/inc/it201i_2012.pdf>, NY CLS Tax § 615(g), <http://tax.illinois.gov/taxforms/incmcurrentyear/business/fiduciary/il-1041-instr.pdf> [↑](#footnote-ref-472)
472. Treas. Reg. §1.642(c)-3(b)(2) and Treas. Reg. §1.643(a)-5(b). [↑](#footnote-ref-473)
473. Treas. Reg. §1.642(c)-3(b)(2), Example 1 shows mere ordering rules to be insufficient. [↑](#footnote-ref-474)
474. 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. [↑](#footnote-ref-475)
475. Rev. Rul. 79-223. [↑](#footnote-ref-476)
476. Treas. Reg. §1.662(b)-2, Example 1, specifically paragraph (e). [↑](#footnote-ref-477)
477. See the discussion of the *Old Colony* case discussed in footnote 353. While Old Colony should be controlling, be aware that there is a seemingly negative precedent from a 2nd Circuit case, *Brownstone v. United States*, 465 F.3d 525 (2d Cir. N.Y. 2006), in which case H’s will established a trust which granted W a broad testamentary general power of appointment. W died and appointed the trust to *her estate*, and her will then made distributions to various charities (query why the POA did not simply pay to charities directly?). The 2nd Circuit differentiated *Old Colony* and denied the deduction because H’s will did not mention charity as a potential beneficiary at all – it was not “pursuant to” the governing instrument. It is a dubious conclusion and probably violates *Old Colony* precedent. That said, to be safe, *especially* if you are in the 2nd Circuit (Vermont, New York and Connecticut). However, name charities specifically as potential appointees, rather than rely on broad power to appoint to any “persons” as was the case in *Brownstone* and the *Weir* case, another 2nd Circuit case it cited. See the language in the PLRs noted below. [↑](#footnote-ref-478)
478. PLR 2012-25004; similarly, PLR 2009-06008 allowed the §642(c) deduction through exercise of an LPOA [↑](#footnote-ref-479)
479. For more detail on the tax effect of amendments made through decanting, reformation, etc. under state law, see Part VII of this outline. For taxpayer-positive rulings permitting charitable deductions from an estate or trust instrument resulting from a settlement agreement/contest, see Rev. Rul. 59-15, 1959-1 C.B. 164, citing *Emanuelson v. United States*, 159 F. Supp. 34 (Conn. 1958), which held that a settlement agreement arising from a will contest qualifies as a governing instrument for purposes of § 642(c). See also *Estate of Wright v. United States*, 677 F.2d 53 (9th Cir. 1982), cert. denied, 459 U.S. 909, 103 S. Ct. 214 (1982); *Middleton v. United States*, 99 F.Supp. 801 (D.C. Pa. 1951) (similar). [↑](#footnote-ref-480)
480. *Harvey C. Hubbell Trust v. Comm.*, T.C. Summ. Op. 2016-67. [↑](#footnote-ref-481)
481. CCA 2016-51013. [↑](#footnote-ref-482)
482. PLR 2014-38014. [↑](#footnote-ref-483)
483. See also IRS CCA 2008-48020, which similarly denied any §642(c) deduction (and denied qualification as a “designated beneficiary”) when a trust was reformed, because the changes to the distribution scheme were not sufficient to make subsequent distributions “pursuant to the governing instrument”. The IRS had a better case for denying see through trust qualification, because pursuant to those regulations a trust must be named and in existence as beneficiary at the time of death, but the denial of the post-amendment tax effect for other purposes is a bit dubious, as noted above. [↑](#footnote-ref-484)
484. Rev. Rul. 2004-5. The ruling only addresses partnerships, but the rationale of the ruling would appear to extend to other pass through business entities, such as S corps *or even a single member LLC*. [↑](#footnote-ref-485)
485. Treas. Reg. §1.641(c)-1(d)(2)(ii) provides: “Special rule for charitable contributions. If a deduction described in paragraph (d)(2)(i) of this section is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion [of the ESBT] pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1). The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.” [↑](#footnote-ref-486)
486. See FSA 2001-40080, which basically followed Rev. Rul. 2004-5 in holding that a trust can take the §642(c) deduction even if not authorized in the trust instrument if made by the partnership, but noting that “Any attempt to pass a charitable deduction from one trust to another trust as its beneficiary is improper and impermissible.” [↑](#footnote-ref-487)
487. There is a very 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 and *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937). However, it is safest to assume in planning stage that sourcing is required, as some courts have so concluded: *Crestar Bank v. IRS*, 47 F.Supp. 2d 670 (E.D. Va. 1999), also *Mott v.United States*, 462 F.2d 512 (Ct. Cl. 1972). [↑](#footnote-ref-488)
488. IRS CCA Memo 2010-42023. [↑](#footnote-ref-489)
489. *Green v. United States*, 2015 U.S. Dist. LEXIS 151539 (W.D. Okla. 2015) which had granted the deduction for the full fair market value, not just basis, was just overturned by the Tenth Circuit: <https://www.ca10.uscourts.gov/opinions/16/16-6371.pdf>. [↑](#footnote-ref-490)
490. *O'Bryan v. Commissioner*, 75 T.C. 304 (T.C. 1980). [↑](#footnote-ref-491)
491. IRC §681(a), Treas. Reg. §1.642(c)-3(d) and (e). [↑](#footnote-ref-492)
492. Treas. Reg. §1.681(a)-2(a) and (b)(3) – it’s a convoluted statute, best understood by reading examples in (c), except remember that the percentage limitations of IRC §170 referenced in those examples (30%/20%) were amended after those examples were written by the Tax Reform Act of 1969 (now 50%/30%). [↑](#footnote-ref-493)
493. As of 2017, the top corporate rate, applicable to private foundations operating as non-profit corporations when they pay UBIT, is 35% with potential for 10% deduction under §512(b)(10), as opposed to 39.6% top rate for private foundations operating as trusts, but which can take a better tax deduction under §512(b)(11), especially if the UBTI is in turn distributed to public charities, as discussed above. See Treas. Reg. § 1.512(b)-1(g). Tax reform lowers those top rates starting in 2018 to 21% and 37% respectively. The IRS sums up the difference as follows in its Publication 598 on UBTI: “Deduction limits. An exempt organization that is subject to the unrelated business income tax at corporate rates is allowed a deduction for charitable contributions up to 10% of its unrelated business taxable income computed without regard to the deduction for contributions. An exempt trust that is subject to the unrelated business income tax at trust rates generally is allowed a deduction for charitable contributions in the same amounts as allowed for individuals. However, the limit on the deduction is determined in relation to the trust's unrelated business taxable income computed without regard to the deduction, rather than in relation to adjusted gross income. Contributions in excess of the limits just described may be carried over to the next 5 tax years. A contribution carryover isn’t allowed, however, to the extent that it increases an NOL carryover.” Also, see page 16 of Instructions for Form 990-T at <https://www.irs.gov/pub/irs-pdf/i990t.pdf>. [↑](#footnote-ref-494)
494. IRC §6034, Treas. Reg. § 1.6034-1(a). IRC § 6652(c)(2) provides for separate penalties of $10 a day, up to a maximum of $5,000, against both the trust and the trustee for not filing Form 1041-A on time, unless there is reasonable cause. [↑](#footnote-ref-495)
495. 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, and CLE materials by this author and attorney Kevin Ghassomian on Incomplete Gift Non Grantor Trusts for upcoming CLE on January 7, 2015 at www.nbi-sems.com. [↑](#footnote-ref-496)
496. I refer to “DINGs” or Delaware Incomplete Gift Non-Grantor Trusts” throughout this paper for simplicity and since the early PLRs used DE law, but you can also establish INGs in other states. E.g. NV (NRS §166.040(2)(b), OH (Ohio R.C. §5816.05(C)), SD (S.D. Cod. Laws §15-16-2(2)(b) and DE (12 Del. Code §3570(11)(b)(2) all specifically permit a settlor to retain lifetime LPOAs, which were a factor in the recent ING PLRs. Not all do. [↑](#footnote-ref-497)
497. Pease limitations do not apply to non-grantor trusts and estates. IRC §68(e). Starting in tax years beginning after December 31, 2017 but before January 1, 2026, they are also eliminated for individuals, at least for now. IRC §68(f). [↑](#footnote-ref-498)
498. 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 the top bracket. See <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. [↑](#footnote-ref-499)
499. E.g. *CCH Multistate Guide to Trusts and Trust Administration*, Jeffrey A. Schoenblum, or various CLEs from Richard Nenno, such as *Planning to Minimize or Avoid State Income Tax on Trusts*, 34 ACTEC L.J. 131 (2008). My own charts have additional important factors not addressed in those, i.e. source income rules. see “ING Trusts – Not *Just* for State Tax Avoidance”, available at <http://ultimateestateplanner.com/programs/dings-nings-technical-planning-issues/>. [↑](#footnote-ref-500)
500. For timing of transfers and assignment of income doctrine, see Rev. Rul. 78-197 discussion and acquiescence to *Palmer v. Commissioner*, 62 T.C. 684 (1974), aff'd on another issue, 523 F.2d 1308 (8th Cir. 1975). [↑](#footnote-ref-501)
501. For a discussion of this concept, and why states are Constitutionally barred from asserting tax jurisdiction over such sales of intangibles when sold by a non-resident or non-resident trust, see *Ed Morrow on Corrigan v. Testa: Avoiding State Income Tax on Source Income,* LISI Income Tax Planning Newsletter #93 (May 25, 2016). [↑](#footnote-ref-502)
502. IRC §7701(a) for definition of “person” – equally, e.g., an S corporation might establish and be a beneficiary of a charitable remainder trust. See IRC §664(d) for basic CRAT and CRUT definitions that include “persons”. [↑](#footnote-ref-503)
503. Rev. Rul. 2002-20 contains an exception, however, for a discretionary trust for a "financially disabled" beneficiary, as defined under IRC §6511(h)(2)(A), as beneficiary of a CRT, and the CRT may last for that beneficiary’s lifetime. The remainder is either payable to the bene's estate or, after reimbursing the state for any Medicaid benefits provided to the individual, subject to his or her general testamentary power. [↑](#footnote-ref-504)
504. PLR 9821029. [↑](#footnote-ref-505)
505. IRS GCM 39707. [↑](#footnote-ref-506)
506. Available at [www.ultimateestateplanner.com](http://www.ultimateestateplanner.com): INGs: Not *Just* for State Income Tax Avoidance! [↑](#footnote-ref-507)
507. IRC §664(c)(2). With state income taxes, it could even exceed 100% tax! [↑](#footnote-ref-508)
508. Treas. Reg. §1.652(b)-1. [↑](#footnote-ref-509)
509. IRC §512 reads in part “(a)(1) General rule. Except as otherwise provided in this subsection, the term “unrelated business taxable income” means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it”.

     IRC §513(a) then defines the term “(a) General rule. The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption \*\*\*\*.

     IRC §513(b) later does have a special rule for trusts, but it does not apply to our situation: “(b) Special rule for trusts. The term "unrelated trade or business" means, in the case of--

     (1) a trust computing its unrelated business taxable income under section 512 for purposes of section 681; or

     (2) a trust described in section 401(a), or section 501(c)(17), which is exempt from tax under section 501(a);

     any trade or business regularly carried on by such trust or by a partnership of which it is a member.” [↑](#footnote-ref-510)
510. E.g. IRC §702(b) (partnerships), IRC §1366(b)(S corporations). [↑](#footnote-ref-511)
511. Compare discussion of UBTI reporting by partnerships on page 15 of Partner’s Instructions for Schedule K-1 (Form 1065), <https://www.irs.gov/pub/irs-pdf/i1065sk1.pdf> and page 42 of Instructions for Form 1065 at <https://www.irs.gov/pub/irs-pdf/i1041.pdf> with the Instructions for Schedule K-1 for Estates and Trusts, which only mention UBTI in regards to CRTs and have no requirement for reporting UBTI to tax exempt beneficiaries. [↑](#footnote-ref-512)
512. Treas. Reg. § 1.642(c)-2(d); § 1.664-1(a)(5)(iii). IRS General Counsel Memoranda 39707 (PLR 8810006). [↑](#footnote-ref-513)
513. 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 and as of 2017 will rise to $415,051 (single) and $466,951 (married filing jointly). If someone has $100,000 of itemized deductions, that threshold may approximate $515,051/$566,951 AGI, since taxable income is calculated *after* the standard or itemized deductions and exemptions (phase outs complicate the calculation, but the point is you have to have a darn high AGI to reach the top tax bracket, far less than 1% of taxpayers reach the highest bracket). [↑](#footnote-ref-514)
514. 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? See *Atkinson v. Commissioner*, 309 F.3d 129 (11th Cir. 2002) and CCA 2006-28026, both holding that impeccably drafted but improperly administered CRTs can be disqualified – even if the charity is only helped, not harmed in any way. [↑](#footnote-ref-515)
515. 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. [↑](#footnote-ref-516)
516. Discussed in Part I, see IRC §2207A and your state equivalent, such as Ohio R.C. §2113.86(I). [↑](#footnote-ref-517)
517. 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. [↑](#footnote-ref-518)
518. See Part VII for authority and discussions of potential for tax effect of amendments to irrevocable trusts [↑](#footnote-ref-519)
519. This is why most decanting statutes specifically exclude marital trusts and trust protector/amendment provisions had better do the same – see TAM 9525002 for a cautionary tale of good intentions gone awry where the trust allowed “either the trustee or any beneficiary to apply to a court of competent jurisdiction to amend this Agreement if the purposes of this Agreement may be defeated or hindered because of change in circumstance or change in law. The court may amend the terms of this Agreement and restrict or remove any of the powers, duties, rights and privileges of the Trustee, the beneficiaries, or any other person.” The government held that the power to amend disqualified the trust for marital deduction treatment notwithstanding a general provision that “the grantor intends that the Marital Trust . . . shall be available for the federal estate tax marital deduction”. The IRS rejected reasonable arguments that the power to amend “adds nothing to the power already held by any court having jurisdiction over the trust” and that the power to amend was limited by the statement of intent to qualify for the marital deduction. [↑](#footnote-ref-520)
520. Many paraphrased from *Restatement of Property, Donative Transfers*, 2nd and 3d – see §17.1 et seq. [↑](#footnote-ref-521)
521. See Uniform Power of Appointment Act, §305, Restatement Third of Property: Wills and Other Donative Transfers §§ 19.13 and 19.14 [↑](#footnote-ref-522)
522. Remember, the default rule, unless the power of appointment clearly implies otherwise, is that powers are *exclusionary* rather than *nonexclusionary,* e.g., if I can appoint to my descendants, I can appoint to one favored grandchild and *exclude everyone else who is my descendant.* A very large number of settlors would dislike this result, yet that is how most powers of appointment are drafted. Yet many want to grant some flexibility to the power holder. The sentence above seeks a compromise position that may be palatable to many clients. See Uniform Power of Appointment Act §203, Restatement of Property, Third, Donative Transfers, §17.5. For a recent case discussing this issue, see *Sefton v. Sefton*, 2015 WL 1870302 (Cal.App. 4 Dist. April 24, 2015), holding that under prior California law, which at that time followed the old English minority rule that powers were non-exclusionary, the power holder could not exclude one of their three children from exercise of a power of appointment. [↑](#footnote-ref-523)
523. 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 is clear that a power’s status as limited or general depends on the actual situation at any given time. See *Restatement of Property, Third, Donative Transfers*, § 17.3, comment d. [↑](#footnote-ref-524)
524. Many states will require that a Will refer specifically to a trust’s power of appointment rather than permit to be effective, but this begs the question of whether a different written exercise, such as through a living trust, need be as specific. See, e.g., [Ohio R.C. 2107.521](https://codes.ohio.gov/ohio-revised-code/section-2107.521): “No provision of a will exercises a power of appointment held by the testator unless specific reference is made to the power.” [↑](#footnote-ref-525)
525. 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 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. [↑](#footnote-ref-526)
526. *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, 88 N.Y.S.2d 446 (1949)](https://case-law.vlex.com/vid/195-misc-1017-in-625013191), 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 (i.e. children had no POA)*. 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, but *it essentially gave them a GPOA*. Surprise! I doubt most practitioners would catch the import of a clause similar to this case. Examine any trust that was funded with a specific clause like this, perhaps you have an argument for estate inclusion (which may NOT be desired for larger estates, with loss assets, etc.). Note that this case may be decided slightly differently if under Ca Probate Code §674 or a state embracing the Restatement 3d Property, Donative Transfers §19.12(c) (a change from the 2nd Restatement), which permits appointing to a permissible appointee’s issue in the event the appointee predeceases, under a quasi-anti-lapse theory, even for non-relatives. Restatement (*First*) of Property §359(2):“The donee of a special power can effectively exercise it by creating in an object an interest for life and a special power to appoint among persons ***all of whom are objects of the original power***, unless the donor manifests a contrary intent.”. [↑](#footnote-ref-527)
527. Restatement of Property, Third, Donative Transfers, §19.9 – even if the document requires “by will”, the default rule is to permit a revocable living trust, as long as it is still revocable at a power holder’s death, to exercise a testamentary POA, so a failure to probate a will should not be a factor. However, a conservative trustee might insist on the will contest period running to ensure the will (or trust) is not invalid for lack of capacity/undue influence – indemnifying the trustee who has no contrary actual knowledge of dispute for making distributions pursuant to a facially valid exercise of a power of appointment may be a good idea for this reason. See *In Re Meyer*, 987 P.2d 822 (Ariz. Ct. App. 1999), in which the Court of Appeals of Arizona found that it was not necessary to probate a will for the testamentary power of appointment to be effective, declaring that “The parties have not cited, and we have not found, any case from any jurisdiction that holds, one way or the other, that a testamentary power of appointment is not operative unless the donee's will that exercises the power is probated.” Contrary to *Meyer*, holding that probate of the will is required, is *Estate of Scott*, 77 P.3d 906 (Colo. App. 2003), aff’d 136 P.3d 892 (Colo. 2006). [↑](#footnote-ref-528)
528. 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. [↑](#footnote-ref-529)
529. See list of decanting statutes with analysis of this power at <http://www.sidley.com/state-decanting-statutes/> [↑](#footnote-ref-530)