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Subject: Ed Morrow & Using Spousal Lifetime Access Non-Grantor Trusts (*SLANTs*) After the 2017 Tax Reform

"Most practitioners are well-versed in drafting and planning with irrevocable grantor trusts. Few consider whether, how and when someone may want to craft an intervivos bypass or QTIP trust as a non-grantor trust. Drafting and administering such a trust when a spouse is involved can be tricky.

I refer to intervivos trusts that name a spouse as a potential beneficiary that are wholly or partially non-grantor trusts as spousal lifetime access non-grantor trusts, or SLANTs, a derivation of the commonly used "spousal lifetime access trust" (SLAT), which is usually designed to be a fully grantor trust. SLANTs offer similar asset protection and estate planning benefits to a grantor SLAT or intervivos QTIP trust, but with additional income tax benefits in certain situations.

Most notable of these benefits is avoiding state income tax, especially for those residing in states that do not use settlor or beneficiary residency as a determining factor in determining trust residency and taxation. This even includes New York, which passed specific legislation against incomplete gift, non-grantor trusts ("INGs")(see separate companion LISI article specific to New York).

The Tax Cut and Jobs Act of 2017 adds further rationale for using such trusts, even for source income, due to the new qualified business income deduction and the new state and local income tax ("SALT") and mortgage interest deduction limits that have no related party rules to prevent related taxpayers, including non-grantor trusts, from taking their own bite at the apple.

SLANTs that do not make the QTIP election also open up the opportunity to shift income tax and obtain much better charitable deductions, which are curtailed if not eliminated for most individual taxpayers now. Unlike INGs, such SLANTs have the additional ability to exploit the newly doubled (and possibly short-lived) lifetime gift tax exclusion, not only for traditional downstream planning, but also for more counterintuitive upstream planning.

The estate tax affects fewer taxpayers every year, and its ultimate fate is still subject to unpredictable political whims (not to mention the unpredictable timing of death itself). By contrast, income tax savings techniques usually involve a more immediate and predictable time window. The potential state and federal income tax savings through using SLANTs, INGs and other non-grantor trusts has dramatically increased with tax reform. The reduced importance of the estate tax for many taxpayers will mean that such trusts involve less estate tax savings opportunity cost by foregoing the traditionally sought leverage of grantor trust status."

Ed Morrow provides members with his commentary on the benefits of using Spousal Lifetime Access Non-Grantor Trusts (*SLANTs*) after the Tax Cuts and Jobs Act. This newsletter is being published contemporaneously with a separate newsletter focusing on unique New York State and New York City income tax law surrounding irrevocable non-grantor trusts. Members should look for that newsletter later this week for specific application of the trust planning ideas in this newsletter to New York residents. An added benefit of Ed's commentary is his handy chart that compares SLAT v. Inter Vivos QTIP v. DING v. SLANT Intervivos Irrevocable Trust designs, which can be found at this link: Ed Morrow's Chart

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Now, here is Ed Morrow's commentary:

EXECUTIVE SUMMARY:

Most practitioners are well-versed in drafting and planning with irrevocable grantor trusts. Few consider whether, how and when someone may want to craft an intervivos bypass or QTIP trust as a *non-grantor* trust. Drafting and administering such trusts when a spouse is involved can be tricky.

I refer to intervivos trusts that name a spouse as a potential beneficiary that are wholly or partially non-grantor trusts as spousal lifetime access non-grantor trusts, or *SLANTs*, a derivation of the commonly used “spousal lifetime access trust” (*SLAT*), which is usually designed to be a fully grantor trust.[1] *SLANTs* offer similar asset protection and estate planning benefits to a grantor *SLAT* or intervivos QTIP trust, but with additional income tax benefits in certain situations.

Most notable of these benefits is avoiding state income tax, especially for those residing in states that do not use settlor or beneficiary residency as a determining factor in determining trust residency and taxation. This even includes New York, which passed specific legislation against incomplete gift, non-grantor trusts (“INGs”)(see separate companion LISI article specific to New York). Indeed, *SLANTs* are in many ways a viable alternative to using *INGs*, with arguably more certainty and fewer arguments for retained nexus.

The Tax Cut and Jobs Act of 2017 adds further rationale for using such trusts due to the new qualified business income deduction and the new state and local income tax (“*SALT*”) deduction limits that have no related party rules to prevent related taxpayers, including non-grantor trusts, from taking their own bite at the apple to get around these new marriage penalties.[2]

SLANTs that do not make the QTIP election also open up the opportunity to shift income tax and obtain much better charitable deductions, which are sharply curtailed if not eliminated for most individual taxpayers now. Unlike INGs, such SLANTs have the additional ability to exploit the newly doubled (and possibly short-lived) gift tax exclusion, not only for traditional downstream planning, but also for more counterintuitive upstream planning.

The estate tax affects fewer taxpayers every year, and its ultimate fate is still subject to unpredictable political whims (not to mention the unpredictable timing of death itself). By contrast, income tax savings techniques usually involve a more immediate and predictable time window. The potential income tax savings through using SLANTs, incomplete gift, non-grantor trusts (INGs) and other non-grantor trusts has dramatically increased with tax reform.

The reduced importance of the estate tax for many taxpayers will mean that such trusts involve less estate tax savings opportunity cost by foregoing the traditionally sought leverage of grantor trust status. Now more than ever,

we must understand how to structure trusts to be as income-tax efficient as possible while keeping true to client's non-tax estate planning goals.

COMMENT:

This newsletter will first review the basics of intervivos QTIP trusts and explore how to draft and administer them as partially *non-grantor* trusts if desired, which may be the most compelling to residents of New York, which has specific legislation targeting *incomplete gift* non grantor trusts (INGs), or for when clients want to keep their lifetime gift tax exclusion or use it elsewhere. Secondly, we'll address how intervivos bypass trusts (a.k.a. *SLATs*) can also be transformed into non-grantor trusts and open up even more tax planning opportunity for those willing to part with some of their newly increased gift tax exclusion. This article will refer to such trusts that are partially or wholly non-grantor trusts as *SLANTs* (**s**pousal **l**ifetime **a**ccess **n**on-grantor **t**rusts), even though single persons could also use the non-QTIP version of a *SLANT* with non-spouse beneficiaries (without the worry of grantor trust spousal attribution rules). Lastly, we'll explore the various practical issues that may arise in administration and the opportunity that such designs unleash, for both state as well as federal income tax purposes, including exploiting the new 20% qualified business income deduction and keeping more deductibility of the newly limited *SALT* deductions.

Non-Income Tax Reasons for Intervivos Bypass or QTIP Trusts

People establish irrevocable trusts that include spouses for many non-tax reasons:

- to comply with a pre or postnuptial agreement;
- to allow children from a prior marriage to receive other assets so that the probate of the settlor's estate need not involve the spouse, causing less chance for friction, litigation and delay;
- to satisfy a state's spousal elective share, depending on the state;[3]
- to create more financial certainty for the donee spouse and peace of mind;
- to protect assets from creditors of *either* spouse, without the uncertainty accorded self-settled asset protection trusts (especially for residents of states that have not passed specific legislation); in

many states protection continues even if the trust includes the donor after the donee spouse's death and for non-QTIP trusts the terms may even include "repeal and replace" "floating spouse" provisions;

There are also many state and federal *transfer* tax reasons to establish such trusts, such as using the substantially increased gift tax exclusion before the increase potentially disappears in 2026 (increased from $5.49 million in 2017 to $11.18 million in 2018).[4] This article, however, will focus on *income tax* reasons for *SLANTs* that will still be important even if the federal estate tax is eventually repealed, the settlor's estate is under the exemptions and/or the taxpayer resides in a state without separate estate or inheritance taxes.[5]

Creating an Intervivos QTIP Trust

Creating an intervivos QTIP trust that is a completed gift is relatively simple. For a gift to a trust to qualify for the intervivos QTIP marital deduction it must:[6]

1) Be funded by donor spouse;
2) Grant the donee spouse a "qualifying income interest for life";
3) Be to a donee spouse who is a United States citizen at the time the gift is made;[7]
4) Be subject to an irrevocable QTIP election on a timely filed IRS Form 709 gift tax return.[8]

The "qualifying income interest for life" requirement merits examining a bit further, but readers are no doubt familiar with these rules since this requirement is essentially the same as the more ubiquitous QTIP trust funded at a settlor's death. It requires either that all the net income to be paid annually, or for the spouse to be able to *withdraw* all the net income annually – no trustee or other party can have the discretion to accumulate this income without the spouse's consent. "Income" for these purposes is not taxable income, it is trust accounting income.[9] An exclusive and unrestricted right to use a residence for life qualifies as to that asset.[10] No party can have a lifetime power of appointment or power to make distributions to anyone or any entity other than the donee spouse during the donee spouse's lifetime.[11]

A "floating spouse" provision that removes an income interest upon divorce would disqualify a trust from making the QTIP election, nor can it be removed if the spouse remarries after death of a settlor.[12] A cessor clause

or any trust protector or trustee amendment or decanting power that would enable removal of this income right would also disqualify the trust from a QTIP election. While it is permissible to fund, retain or purchase assets unproductive of income in the trust, the spouse must have the ability to make non-income producing property productive of income or convert it within a reasonable time.[13]

Important to understand for this article is that certain rights and powers are very common and *permitted* in QTIP trusts, but are not *required*. These include the ability for the trustee or any other party to distribute more than the net income (i.e. principal) to the donee spouse (under either ascertainable or discretionary standards),[14] the ability for the donee spouse to hold a testamentary power of appointment, or a reversionary interest in the donor spouse upon the death of the donee spouse (even split between a bypass/QTIP trust).[15]

Trickier - Creating an Intervivos QTIP Trust That is in part a *Non-Grantor* Trust

Most assume that an intervivos QTIP is entirely, 100%, a grantor trust as to the settlor spouse, as to both accounting income and taxable income that is principal (e.g. capital gains). *Usually, it is*. But it could be drafted in such a way as to be a grantor trust only as to accounting income, and a non-grantor trust as to all other income, such as large capital gains, which are usually allocated to principal.

Clarifying How *Partially* Grantor Trusts are Taxed

Before we explore the various grantor trust code sections, readers may be scratching their heads about this idea of "partial grantor trust" status. After all, it's rare to have partially grantor trusts, and even rarer for a tax preparer to properly divide and report the income as such even if it is. The regulations, however, are quite clear – you can have a partially grantor trust as to either income or principal, over income from certain assets and not others, or over a fraction of a trust.[16] The following section will discuss the former – dividing between accounting income and income attributable to principal (typically capital gains but could include extraordinary dividends/distributions).

A Walk Through the Grantor Trust Rules Pertaining to a *SLANT* - Avoiding IRC §671-679 to Ensure Non-Grantor Trust Status for Capital

Gains (Taxable Income Allocated to Principal) for QTIPs, or All Taxable Income for Non-QTIPs

Various grantor trust rules will *usually* require that all income (both accounting income and income such as capital gains typically attributable to principal) of an intervivos QTIP trust or even most other SLATs be taxed to the settlor/donor spouse under IRC §671 et seq. *But not always*. Let's go out of order and start with the most obvious of these grantor trust code sections that usually apply to intervivos QTIPs and SLATs, IRC §677, which merits our quoting in part:

> **§677** - "(a) General rule The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—
>
> > (1) distributed to the grantor or the grantor's spouse;
> > (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or"

In most intervivos QTIPs the accounting income is distributed to the grantor's spouse, triggering §677(a)(1) as to the accounting income, making it taxable to the grantor.[17] Moreover, in most intervivos QTIPs the taxable income attributable to accounting principal may be accumulated for future distribution to the grantor's spouse, under either a discretionary or ascertainable standard ("health, education, maintenance or support"), making the capital gains or other income attributable to principal taxable to the grantor under §677(a)(2). Thus, ordinarily, all taxable income of an intervivos QTIP or SLAT is taxable to the grantor, including capital gains or other income attributable to principal.

However, as we stated previously, an intervivos QTIP does not *have* to hold or accumulate principal for future distribution to a spouse. There need not be *any* ability to distribute principal, or it might only be permitted with the consent of an *adverse party*. For grantor trust purposes (which may be slightly different from the definition for estate/gift tax purposes), an adverse party is "any person having a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust."[18] In either of those cases,

§677(a)(2) would not be triggered, even if income ultimately went to the settlor or settlor's spouse.[19]

Let's examine two examples from the regulations that are substantially similar to our hypothetical *SLANT.* We'll pluck the first one from the §677 regulations.[20] To paraphrase Treas. Reg. §1.677(a)-1(g), Example 1, if an intervivos QTIP pays income only to the donee spouse during the donee spouse's lifetime, remainder to children, and the grantor (and spouse, via §672 attribution) retains no other rights or powers that would trigger §671-679, and the trust and local law apply capital gains to corpus rather than income, any interest/dividends (accounting income) would be taxed to the grantor, and any capital gains or other income allocated to principal would be taxed to the trust itself under non-grantor trust tax principles of Parts A-D of subchapter J.[21] The additional beauty of this, surprisingly, is that the expenses allocable to corpus can be deducted against the grantor trust portion rather than the non-grantor trust portion, enabling even more income to be trapped in the state income tax advantageous non-grantor trust portion, and reducing the income that would otherwise still be subject to the grantor's state of residency.[22]

If the trustee (or any non-adverse party) has the discretion to pay principal to the settlor's spouse, even if limited to health, education and support, then the capital gains would also be taxed to the grantor.[23]

Our second apt example from regulations comes from S corporation regulations, but specifically highlights the difference between a typical QTIP (i) and our proposed SLANT (iii), and is short enough to quote in full:[24]

> (i)Transfers to QTIP trust. On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. **In addition, corpus may be distributed to B**, at the trustee's discretion, during B's lifetime. However, **under section 677(a), A is treated as the owner of the trust**. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(iii)Transfers to QTIP trust where no corpus distribution is permitted. **Assume the same facts as in paragraph (i)** of this Example 10, **except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B's surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on gross income allocable to corpus.** Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST. [note, as we'll discuss later herein, an electing small business trust (ESBT) election is required and incredibly advantageous if the *SLANT* holds S corporation stock].

Once the §677 gauntlet is understood and put in perspective, analyzing the remaining provisions that might affect a trust that could benefit a spouse is taxed is relatively easy and relies on time worn principles of grantor trust taxation. To ensure non-grantor trust status involves avoiding many of the triggers that we usually insist on for irrevocable grantor trust planning, and avoiding the various grantor powers that cause ING trusts to be incomplete gifts (see the Venn diagrams in the webinar PowerPoint), all while keeping compliant with the intervivos QTIP rules. Let's walk through the basics of a few more important grantor trust code sections:

IRC §672 is not a grantor trust trigger in itself, but contains the definitions for adverse and non-adverse parties and spousal attribution important throughout the remaining grantor trust rules. We discussed the basic definition of adverse party above: "any person having a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust", but it's worth fleshing out further.

Independent trustees are nonadverse parties even though they may have fiduciary duties to those who would be adverse parties.[25]

If a beneficiary is entitled to a pecuniary amount of $200,000 at the death of the primary beneficiary, that person may have a substantial beneficial interest, but if the trust corpus is $5 million, most payments to the primary beneficiary would not *adversely affect* that person's interest, until the trust corpus reduces to under $200,000. By contrast, someone who is a 0.005%

remainderman would be adversely affected by a distribution to the primary beneficiary, but the interest may not be "substantial", which it would not be if the "value in relation to the total value of the property subject to the power is not insignificant."[26] What does this mean as a practical matter? 1%? 0.1%? 5%? While my personal opinion is that 1% should be significant, I have no authority for that guess and we have no clear line in the sand on these terms – a judge may just "know it when she sees it" to paraphrase Justice Potter Stewart's famous quote. In two cases where beneficiaries were very unlikely to ever inherit anything, the courts ruled the parties were non-adverse.[27] In one of the recent various "ING" PLRs, power of appointment committee members receiving 5% of the residuary interest were considered adverse, but the ruling had no real analysis or discussion of the issue.[28]

More complicated still is determining if an adverse party consent is sufficient to avoid grantor trust status as to the *entire trust*: "(b) Ordinarily, a beneficiary will be an adverse party, but if his right to share in the income or corpus of a trust is limited to only a part, he may be an adverse party only as to that part."[29] Could this be interpreted to require ***all*** adverse parties (remaindermen) to consent in order for the entire trust to be a non-grantor trust (or at least all primary beneficiaries of any subtrusts created by division after death)? That would be easy when one child is the sole remainderman, but could raise a problem in many other situations. None of the dozens of ING PLRs required unanimous remainder beneficiary consent yet were ruled to be 100% non-grantor, but frustratingly, the IRS never bothered in *any* of the ING PLRs to cite Treas. Reg. §1-672(a)-1 nor discuss in the slightest *why* the distribution committee (which in some rulings omits remaindermen and/or adds parties who are not remaindermen) was adverse under IRC §672. The PLRs tersely concluded that the trusts had "none of the circumstances that would cause Grantor to be treated as the owner of any portion of Trust under §§ 673, 674, 676, or 677", without any discussion on that point.[30] Of course, PLRs cannot be relied on or cited for precedent either.

The closest example in §1.672(a)-1 to a "SLANT" or "ING" that would permit a distribution to the grantor or spouse with consent of an adverse party only gives an example of a trust with only one remainderman, who was deemed adverse.[31] There is no example of a trust with multiple remainderman yet only one consenting.

There is an example where a grantor could revoke a trust with consent of only one of four *income* beneficiaries and it was deemed that the trust was thus only ¼ non-grantor and ¾ grantor.[32] One could question whether that example in the regulation is a rational interpretation of IRC §672(a), since the income beneficiary in such case is clearly adversely affected by the exercise of their power and would lose their entire interest if the trust were revoked. However, few practitioners want to battle a regulation.

Some may feel the liberal rulings in the ING PLRs provide plenty of cover on this issue, or read less uncertainty into the regulations, but if a practitioner wishes to be certain of non-grantor status without getting a PLR, it may be best to require unanimous consent of remainder beneficiaries to distribute to a spouse, or at least majority consent. Alternatively, but slightly less certain, the settlor could name an LLC benefitting the same intended beneficiaries as the remainderman, such that the LLC would be the sole adverse party whose consent would be required. The LLC could be governed by majority vote of the members or probably even manager-managed.

§673 reversionary interests– unlike some intervivos QTIPs that might revert to a grantor upon the death of a donee spouse, a settlor wishing to create a non-grantor trust as to principal should avoid any reversion, otherwise §673 would regard the grantor's reversionary interest as a grantor trust trigger as to the principal.[33] §673 can cause the entire trust corpus to be treated as a grantor trust if the value of the reversion exceeds 5%.[34] This is calculated under standard actuarial principals, but it doesn't take an actuarial wizard to understand that in most spousal situations a reversion would be worth more than 5%. Any attorney wishing to avoids this grantor trust trigger should eliminate any automatic reversion back to the grantor altogether. However, the grantor spouse might receive assets after the death of the donee spouse through the spouse's exercise of a testamentary power of appointment.

This calculation of the reversion holds true for spousal interests as well.[35] Unlike the *estate* tax provision regarding reversionary interests, this 5% test for grantor trust purposes is calculated at the time of funding rather than later or at the time of death.[36] Importantly for our considerations, there is a special rule for determining the value of a reversionary interest:[37]

> For purposes of subsection (a), the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion in favor of the grantor.

With an *ordinary* intervivos QTIP that contains discretion to pay distributions to a donee spouse beyond accounting income, such a power would likely trigger §673 as well as §677. However, let's hypothesize a trust wherein any power to distribute principal to the donee spouse were only pursuant to a lifetime limited power of appointment held by an adverse party (or parties), and the only power to distribute principal back to the donor spouse is a testamentary limited power of appointment held by the donee spouse and an adverse party or a testamentary general power of appointment.[38]

Is being a mere permissive appointee of trust assets a "reversionary interest" pursuant to §673(a) and if so, would the fact that such a power is held by an adverse party take such a power outside of the grantor trust rules?

"Reversionary interest" is not defined in the code section or regulation.[39] However, the ordinary meaning of a reversion under common law of property and trusts is a property interest *retained* by the donor/grantor after a transfer of less than fee simple which may *entitle* the grantor to receive a portion of the trust in the future under certain conditions.[40] We might expand upon the common law definition if we incorporate the spousal attribution rules of §672(e) to include an interest the grantor's *spouse* might be entitled to, even though this would be considered to be a "remainder" rather than a reversionary interest at common law because it was created by another. Permissive appointees under a power of appointment are *not* regarded as having either a "reversionary" or a "remainder" interest; indeed, it's not a property interest at all.[41] What §673 is addressing is that, in calculating the value of any reversionary (or in the case of a spouse, remainder) interest, that maximum discretion in favor of the grantor (or spouse) should be assumed. In the postulated case where there is no remainder or reversionary interest in the grantor or grantor's spouse AT ALL, what non-fiduciary lifetime limited powers someone may possess in favor of the donee spouse is completely irrelevant.

This is borne out by the numerous incomplete gift, non-grantor trust (a.k.a. ING) PLRs of recent years, and is especially explained by the anomalous

ING PLR that revoked a previous one.[42] Let's explain the general design of these INGs in relation to §673, and then explain how the seemingly more troublesome PLR 2016-42019 actually reinforces why §673 does not apply in our postulated spousal lifetime access non-grantor trust (*SLANT*).

The post-2012 ING PLRs have a trust structure whereby a distribution committee has a lifetime limited power to appoint to the grantor and/or the grantor's spouse and others and the grantor also retained a broad testamentary limited power of appointment. Most PLRs named children or other committee members as takers in default, but one PLR, 2014-26014, contained a provision that had the corpus *revert* to the grantor in the event the committee shrunk to an inadequate number. In most of these PLRs, the IRS concluded without any analysis at all that "an examination of Trust reveals none of the circumstances that would cause Grantor to be treated as the owner of any portion of Trust under §§ 673, 674, 676, or 677." However, the IRS explained a bit more in PLR 2016-42019, in which it revoked PLR 2014-26014, that:

> After reconsideration, we have concluded that the provision in Trust that provides that in the event that both the children are no longer serving as members of the Distribution Committee or if there are fewer than two serving members, **the trust property will be distributed to the grantor** and the trust shall terminate **constitutes a reversionary interest under § 673**. Section 673(a) provides in general that the grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5% of the value of such portion. Under § 673(c), the value of the reversion must be calculated assuming the maximum exercise of discretion in the grantor's favor, which under these facts would be the immediate resignation of all the Distribution Committee members immediately after trust funding, causing the reversionary interest to be worth 100% and causing X to be treated as the owner of the entire trust for purposes of § 671.

This comports with our understanding of §673 reversions discussed above. First, determine if there is a reversion (or remainder for spouse). In PLR 2014-26014 there was clearly a reversionary interest, but the likelihood seemed extremely remote. If *and only if* we find a reversion, even a remote one, the next step is to assume that any discretion will be exercised to the

maximum extent for the grantor and/or spouse. No doubt the drafter of the trust in PLR 2014-26014 did not think of resignation of committee members as an act of discretion – it's certainly not obvious. It was this latter step that was eventually fatal, however, causing grantor trust status to the trust. Notably, neither in PLR 2014-26014 nor in any of the many other ING PLRs is *a lifetime power to appoint to the settlor and/or settlor's spouse a §673 trigger.*

Thus, a lifetime power held by an *adverse party* to appoint principal to a donee- spouse does not by itself implicate §673. It is much easier to avoid §673 with *SLANTs* than for *INGs* because we do not need the complicated distribution committee structure and the various contingencies surrounding its reconstruction, reconstitution and potential demise that plagued the trust in PLR 2014-26014 and its later reversal in PLR 2016-42019.

§674. IRC § 674 may be the most complicated grantor trust section. It has a myriad of exceptions. It generally triggers grantor trust status when trust property is "subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party."[43]

Thus, to cause an intervivos QTIP to be a *non-grantor* trust, for §674 purposes we want to avoid any power by the grantor or spouse, or other non-adverse party, to effect the disposition. In many respects, this is much easier for intervivos QTIPs than for INGs. With a QTIP, the income *has* to be distributed or be available for withdrawal by the donee spouse. A QTIP trust cannot contain a provision to allow income or principal to go to anyone else during the donee spouse's lifetime.

However, we still want to be careful and avoid giving an independent non-adverse trustee, for example, the power to distribute principal for health, education support or any other discretionary standard. By contrast, if children (the likeliest adverse parties) use a lifetime limited power to appoint additional principal to the spouse, this does not trigger §674 because such parties are adverse (though it may carry out DNI through the non-grantor trust rules as a distribution).

Many of the ING powers that might seemingly implicate §674, such as a retained power to veto (consent to) certain distribution decisions or the

settlor-retained lifetime limited powers of appointment, are simply non-existent in a non-grantor intervivos QTIP.

The settlor's testamentary limited power of appointment typically included in an ING brings up an interesting nuance when comparing to an intervivos QTIP. IRC §674(b)(3) excludes the following from being a grantor trust trigger:

> A power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Thus, if we grant the donee spouse beneficiary of an intervivos QTIP a testamentary limited power to appoint by will, this should be an exception that would not cause grantor trust treatment as to principal, as there would be no accumulated income for disposition by the grantor's spouse.

Obviously other common intentionally "defective" §674 grantor trust provisions such as a power to add charitable beneficiaries should also be avoided.[44] Many of the control issues are avoided by choosing an independent trustee.[45]

§675 – IRC § 675 is best known by planners as the genesis of the now ubiquitous "swap power".[46] Obviously this power should be avoided when the goal is to create an intervivos *non-grantor* trust. Other §675 powers to avoid are the power to deal for less than adequate and full consideration, power to borrow without adequate interest or security, actual borrowing of the trust funds under certain circumstances even if there is no explicit power to do so, and voting and investing in stock in which the grantor/trust has a certain level of control.[47]

§676 – IRC §676 is the power that ordinarily snags a revocable living trust, even if neither the settlor nor a spouse is a beneficiary. Less well known is that if a non-adverse party has a power to revest the property in the settlor (or, per §672, a settlor's spouse), this would also trigger §676. This not only includes revocation, but similar powers, such as the power to terminate, alter, amend or appoint.[48] Thus, to safely avoid §676, our *SLANT* trusts should not contain any discretion by *non-adverse* parties (whether as trustee, trust protector, advisor or power of appointment

holder) to distribute corpus to the settlor or settlor's spouse while the settlor is living. Moreover, just as with ING trusts, one has to be careful with overly broad trustee/trust protector powers to amend the trust, since these are usually non-adverse parties.[49] If a trust protector has the power to add the settlor as a beneficiary or appoint to the settlor (a.k.a. a "hybrid-DAPT"), this would trigger grantor trust treatment – probably under §676 as well as under §674.[50]

§678 – Even if all the above grantor trust provisions are avoided, IRC §678 can override non-grantor trust status and shift taxation to anyone who has a power to withdraw income and/or corpus, and perhaps even to those who used to have such a power but allowed it to lapse and retained certain interests or powers in the trust. This is discussed more significantly in a recent LISI article.[51] The most common trigger would be if you give a spouse or any other party a *Crummey* power or "five and five" power of withdrawal - this would thwart wholly non-grantor trust status and cause a wholly or partially beneficiary deemed owner trust, division of which could be complicated to calculate depending on the amounts in question and terms of the trust.

§679 – IRC §679 concerns foreign trusts with U.S. beneficiaries.

Causing Non-Grantor Trust Status for Non-QTIP *SLANTs*

For any intervivos bypass trust that does not seek to qualify for the marital deduction as a QTIP, the trust can be a wholly grantor trust as to both taxable accounting income *and* taxable income attributable to principal. All of the above admonitions regarding intervivos QTIP trusts would apply, but the trust could also require adverse party consent for *distributions of net accounting income as well*, which would make the *entire trust* a non-grantor trust, not just the taxable income attributable to principal.

Because such a trust would not have to mandate that the spouse be the sole income beneficiary during life, nor even be a U.S. citizen, the trust can be used to shift income to other beneficiaries or achieve more advantageous charitable deductions.[52] Of course, such a use is not as optimal for pure estate tax planning (since it could be construed as wasting gift tax exclusion), but there are an increasing number of taxpayers whose net estates come well under the exclusion or who care more about income tax savings, especially after the recent tax reform.

If the design of this trust starts to look eerily similar to an ING without the settlor-retained powers that cause an incomplete gift, that is because we're essentially coming at the same goal from different directions. Indeed, one could have a very similar distribution committee structure comprised of adverse parties (beneficiaries).

Gift Splitting when the Spouse is a Beneficiary or Appointee

For many taxpayers, the $11.18 million or more gift tax exclusion slated for 2018-2025 is plenty, but for various reasons (such as seizing more gift exclusion before the 2026 cliff) married couples may also want to make completed gifts to non-QTIP *SLANTs* and *split the gifts*.[53] Gift-splitting is usually foreclosed when a spouse is a discretionary beneficiary, because neither the spouse's nor the other beneficiaries' actuarial interest can be quantified – this is typically a minor drawback for *SLATs*.[54] By contrast, if a spouse is a mere *appointee* and only eligible to receive distributions through a non-fiduciary lifetime limited power of appointment, this interest is quite easy to quantify – the value would be zero, since the spouse has no property interest under state or federal law. Thus, gift-splitting may still be permitted, depending on how the spouse's interest is structured.

However, one might want to structure the spouse's interest as a true beneficiary eligible for distributions upon an adverse party's consent (not a mere appointee), and it may be desirable not to split gifts for other reasons. Many *SLANTs* would want to grant a donee-spouse a formula general power of appointment to assure a step up in basis on appreciated trust assets at the donee-spouse's death if there is sufficient lifetime exclusion, but granting such a power would also foreclose gift-splitting.[55] If a settlor wishes to retain the flexibility to step up appreciated assets at the donee spouse's death while still splitting gifts, a testamentary *limited* power of appointment might be granted and exercised in such a way as to trigger the Delaware tax trap to cause inclusion, which would not violate the gift-splitting rules.[56]

Administering Trusts to Keep Non-Grantor Trust Status

It's not enough to draft such a trust correctly. One must "walk the walk". If you draft the trust to prohibit payment of life insurance premiums on the settlor, but the trustee does so anyway, it may cause grantor trust status.[57] If you have independent trustees and adverse parties' consent requirements, but the trustee simply takes orders directly from the grantor anyway, it may cause grantor trust status.[58] If you draft the trust correctly,

but then the trustee or an LLC owned by the trust loans money to the grantor or the grantor's LLC, it may cause grantor trust status.[59] And, in probably the most famous revenue ruling of all time, if the trustee sells assets to the grantor/spouse in exchange for a promissory note, this would cause grantor trust status.[60]

In short, it's much easier for a non-grantor trust to inadvertently become a grantor trust than the reverse (at least while the grantor is living). These admonitions may remind some tax professionals of the *Atkinson* case where the 11th Circuit held that improper trust administration retroactively destroyed a perfectly drafted charitable remainder trust (CRT), or the various cases wherein creditors pierce properly drawn third party created spendthrift trusts.[61] Diligent administration matters as much as drafting. This is true for *INGs* as well as *SLANTs*.

Unique S Corporation Issues and Opportunities

As discussed, most intervivos QTIPs and SLATs will be 100% grantor trusts, and therefore qualify to be an S corporation owner without the need of a special filing or election.[62]

Non-grantor (or partially non-grantor) trusts (or their beneficiaries), however, must make a qualified subchapter S trust (QSST) or electing small business trust (ESBT) election for the company to retain its status as an S corporation.[63] The majority of trusts probably use the QSST election, because it forces ongoing income to be fully taxed directly to the beneficiary, similar to a §678 beneficiary-deemed owner trust.[64]

While QSSTs are more tax efficient for the more than 99% of taxpayers who are not in the highest income tax bracket, there still remains a minority for whom the ESBT is more advantageous, such as those in the highest tax bracket who reside in a state with a separate income tax, those fearing creditor/divorce access to forced distributions and those who would be considered passive owners otherwise subject to the 3.8% surtax who might be able to avoid the tax by appointing a co-trustee who is active in the business and trapping the income in trust.

More importantly, for the intervivos QTIP *SLANT* discussed in this article, a QSST election is impossible. Treasury regulations indicate that a spouse/beneficiary of an intervivos QTIP trust cannot make an effective QSST election over the non-grantor portion.[65]

ESBTs are ideal for this purpose. Grantor or partial grantor trusts can clearly still make an ESBT election, but any grantor trust portion is still taxed under the grantor trust rules.[66] Thus, to the extent a SLANT is a grantor trust, the ESBT election is permitted but its practical effect over any grantor trust portion is held in abeyance. As to any portion that is a non-grantor trust, the ESBT permits income to be trapped in and taxed to the trust, even if the S corporation income may appear to be distributed out to beneficiaries. Moreover, this is true even if the ESBT liquidates all its S corporation stock and thereafter ceases to be an ESBT.[67] The ability to make distributions without carrying out distributable net income ("DNI") allows the beneficiaries to access and use funds without getting a corresponding K-1 (except for the small portion, if any, that is attributable to non-S corporation income).

For the middle class, these and other strict ESBT rules are a distinct disadvantage, if not downright punitive. However, ESBT taxation is a substantial benefit to high bracket taxpayers residing in states with a high state income tax, to the extent the corporation's income is not sourced to that state and cannot avoid taxation.

Recent tax reform only adds to the allure of ESBTs, and another potential benefit over QSSTs, by permitting non-resident aliens to be a potential beneficiary of an ESBT as of January 1, 2018.[68] Moreover, the most common type of income for an ESBT to receive now qualifies for an additional 20% tax deduction that many upper middle class individuals may not qualify for if they were QSST beneficiaries.

Unique New Opportunities for *SLANTs* that have Qualified Business Income and/or State and Local Tax Deductions After Tax Reform

While we might typically see *INGs* and *SLANTs* as a technique to avoid state income tax on capital gains from the sale of appreciated assets, tax reform may offer additional ongoing federal tax benefits, regardless of the state residency of the trust or whether it is source income.

The new tax reform law introduces a new 20% deduction for qualified business income.[69] This is discussed in more detail in recent LISI articles such as *Alan Gassman and Brandon Ketron – Demystifying the New Section 199A Deduction for Pass-Through Entities*, LISI Income Tax Planning Newsletter #125 (Jan 4, 2018) and *Stephen Liss & Section 199A - The Great Divide,* LISI Income Tax Planning Newsletter #129 (Jan 24, 2018), and LISI also offers an online 199A calculator.

The most important planning takeaway is that this substantial 20% deduction is subject to phase out and/or complete elimination, yet trusts and estates can take an additional bite of the apple and are not aggregated together with settlors and/or beneficiaries under any related party rules as far as the caps and phase outs of the deduction.[70] To explain this provision in depth is beyond the scope of this article, but let's just take two similar examples to show the potential benefits of the *SLANT*:

> **Example**: John has a business making $300,000 business income (it does not matter whether sole proprietor/Sch C or K-1 from LLC/LP/S corp). His wife Jane is an executive also making $300,000. They have $50,000 of miscellaneous investment income. If John's business is a specified service business, he will receive no Section 199A deduction, because their taxable income is above the $415,000 threshold. Even if his business were not in this disfavored category, his deduction may still be limited or even eliminated, depending on the company's W-2 income and unadjusted basis of all qualified property.

> **Contrasting Example** u*sing SLANT or ING*: John incorporates his business as an S corp (if it is not already), transfers business to ING or SLANT, pays himself $145,000 *reasonable salary* and the remaining $155,000 K-1 profit (ignoring differences in employment taxes) can now qualify for the Section 199A deduction even if it is a specified service business or otherwise limited and to the extent it is trapped in trust is taxed at a top rate of 29.6% (37% top rate – 20%) after deduction (once the top rate is reached at $12,500), saving approximately $11,000/year (not to mention the potential 3.8% savings on self-employment taxes if John's business was not previously an S corp). Moreover, if John's state income tax on the business income (which is likely source income taxable by the state no matter where the trust is sitused) is 6% or $9,300, this amount would still be deductible under the new state and local tax (SALT) deduction rules, which are capped at $10,000 per taxpayer ($5,000 for married filing separate), whereas it would have been completely lost under the new cap had it been paid by John and Jane themselves. This saves a few thousand dollars more. If someone active in the business is a co-trustee of the ING/SLANT, it is very likely (though not 100% certain) that the income also escapes the 3.8% net investment income surtax.[71]

Thus, as to ongoing business income which is likely source income, *SLANTs* offer the ability to gain additional Section 199A deduction and additional state and local income tax (SALT) deductions. Uniquely among taxpayers, of course, a trust can easily lower its taxable income with the distribution deduction by making distributions to beneficiaries during the year, or with an election, within the first 65 days of the following year.[72] This is not true, however, for ESBTs, although ESBTs are now permitted a charitable deduction starting in 2018.[73]

Further, a second non-grantor trust could conceivably be a beneficiary of the first trust so that any pourover beyond the $157,500-$207,500 could be spilled into another trust. To follow our above example, if John's business has a much better year than expected and has $250,000 instead of $150,000 K-1 income, and the trust makes $100,000 of distributions to children, John's wife or even another non-grantor trust, the taxable income for the trust would be reduced to enable the trust to take the full §199A deduction (whether the other beneficiaries could on their received K-1 income would depend on their taxable income of course).

There is no *express* limit on how many trusts can be established to exploit this, but there is a seldom-used provision already in the code that the IRS may resuscitate to combine two or more similar trusts.[74] Treasury has also indicated it will issue "anti-avoidance guidance" on §199A.[75] Moreover, the IRS could trot out the *substance over form* doctrine in abusive cases, in spite of being recently rebuked by the 6th Circuit and 1st Circuit on such overreach.[76] It could also try to apply the newly codified economic substance doctrine but this is unlikely, since the statute has specific exceptions for individual transactions, such as transfers to trust.[77] It could come down to the proverbial "pigs get fat, hogs get slaughtered". Ultimately, the risk that multiple trusts will be collapsed into one should be minimal provided each trust has a substantially independent purpose, such as differing beneficiaries. The risk is probably greater that Congress amends the law to create a related party rule to aggregate and limit the deduction, which it can clearly do if it ever develops the political will to do so.

Avoiding the Family Partnership Rules of IRC §704(e)

In our above example, the transferred business was an S corporation, but if the business is a partnership (or LP/LLC taxed as one), there is an additional and much more complicated hurdle to overcome. IRC §704(e)(1) provides that:

> In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, ***except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor***, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital.

Thus, if the donor renders services to the LP/LLC, he or she should be paid reasonable compensation (guaranteed payment) therefore, just as in the context of S corporation shareholder/employees who must pay themselves a reasonable salary.

If reasonable compensation were the only issue, these rules would be easy to understand. The regulations, however, are *much* more complicated. The issue for most closely-held partnerships, *especially* many of those that would be specified service businesses under Section 199A(d)(2), is that we don't even get to the above rule unless we pass a complex gauntlet of three further tests.[78] The first one is enough to stop many in their tracks: capital must be a material income producing factor of the partnership, otherwise the income will not be part of the donee's distributive share, but the donor's:

> Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.[79]

Many specified service businesses taxed as partnerships whose owners' families would benefit the most from transfers of ownership to non-grantor trusts may not be able to meet this test (and thus, not be able to shift the income). There are even more complexities in the second and third test in the regulations beyond the scope of this newsletter, especially surrounding trusts as donees, but I would commend the reader to another article that concluded after examining these regulations that:

> Many taxpayers will want to avoid the partnership tax rules by placing business operations into an S corporation instead of a partnership, or converting to an FLP (or LLC) taxed as an S corporation…S corporations do not have the same issues that apply to partnerships under Code Sec. 704(e), in that an S corporation's ownership can be donated to another party, who will be taxed on the income reported out to the owners without having to specify [prove] that capital is material.[80]

Another option aside from S corporation status, depending on the value and ownership structure, may be to simply gift/sell 100% of the company so that it's no longer a partnership but a disregarded entity, such as a single member LLC.

Even if Income is Unavoidable State Source Income, *SLANTs* Run the State Brackets and May be Able to Exploit Loopholes in State Taxation of Trusts

In addition to *SLANTs* being able to garner better QBI deductions in some cases than individuals, some states incorporate a highly progressive income tax rate structure for trusts and estates and many states use a trust's federal taxable income as a starting point for their own state income tax, which *SLANTs* may further exploit by indirectly reducing state income tax through federal deductions.

Being able to "run the brackets" is very limited for federal tax purposes, since the highest tax rates start at only $12,500 of income. About half the states follow the federal lead and compress their state income tax brackets or have a flattened rate structure.[81] However, there are quite a few states that mimic their individual progressive tax rate structure for taxation of trusts and estates. Let's take a simple example, using California and New Jersey rates:

A married couple has $250,000 of W-2 income, $600,000 of business income that would be specified service business income (or otherwise limited under the W-2/unadjusted basis tests under 199A). They would not be eligible for any 20% QBI deduction and would be in the top marginal federal bracket of 37% (in CA, 12.3%; in NJ, 8.97%). If they move 3/4 of the business ($450,000 of income) which pays reasonable salaries, into three SLANTs for each of their three children/spouse, let's observe the effects on the marginal brackets, both federal AND state: $30,000 can now be deducted from each trust's income, making the top marginal federal rate 29.6% (37% - 20% deduction), assuming that one of the trustees is active in the business and the 3.8% surtax does not apply. The trust's marginal

state income tax rates would be lowered from 8.97% to 6.37% in New Jersey and from 12.3% to 9.3% in California. Meanwhile, the couple's federal marginal rate on their $400,000 income remaining is lowered to 32% and they would now be able to receive at least a portion of the 20% QBI deduction that is phased out for taxable income between $315,000-$415,000. Moreover, their state marginal brackets would also be reduced to 11.3% in California or 6.37% in New Jersey.

But it gets even better in many states. Most states start their own taxation of trusts with federal taxable income (currently line 22 of Form 1041, for 2018-2025 this would presumably be after any 20% QBI deduction and other deductions), rather than starting with a trust's gross income or adjusted gross income (AGI).[82] Provided the state does not amend its adjustments to add back the QBI deduction, using a non-grantor trust may also generate a 20% deduction indirectly for *state* income tax purposes as well.

By contrast, most states start with federal *adjusted gross* income (AGI) for individuals, which will not be reduced for any 20% §199A deduction, meaning that many individual business owners residing in states with a separate state income tax will *not* receive a separate state income tax deduction. In our example above, if $450,000 of QBI generated $90,000 of deduction that escaped a 7% state income tax through using SLANTs, the state income tax savings would be $6,300.

While no one will be rushing out to establish trusts just to soak up more progressive state income tax brackets or receive 20% state QBI deductions, these savings can add up and are further advantages to consider in the analysis with other federal tax savings and the non-tax benefits.

Installment Sales to SLANTs to Lock in Deferral of Income if SLANTs Sell > 2 Yrs

Disregarded sales to irrevocable grantor trusts are justifiably touted as an important estate tax leveraging strategy, and most practitioners never consider a sale to a non-grantor trust that is a separate taxpayer, which would be *regarded* and trigger tax on any gain. Consider, however, that installment sales to a non-grantor trust can defer gain for the family, even if the asset is expected to be sold in the near future, which a grantor trust *cannot* do, provided the asset is not disposed of by the trust until at least

two years after initial sale. This is subject to the typical limitations and caveats about installment sales.[83]

Such transactions have a few statutory hurdles to overcome, with several overlapping related party rules. The two year rule provides that if a related party buyer sells an asset that was purchased on installment within two years, the gain is then triggered to the original seller.[84] Related parties are very broadly defined.

This can be avoided by selling to the SLANT at least two years prior to the SLANT selling or disposing of the property, but there are two other provisions to avoid. Section 453(g) can accelerate deferred gain in the case of an installment sale of depreciable property to a related party and Section 1239 can cause capital gain to be taxed as ordinary income in the case of sales of depreciable property to a related party. "Related parties" include a non-grantor trust in which a spouse is a beneficiary, but the definition is much narrower than for § 453(e)'s two year rule and would *not* include a non-grantor trust for children.[85] Thus, an intervivos QTIP SLANT would clearly run afoul of §453(g) and §1239(b). However, an ING or SLANT that does *not* name the taxpayer or spouse as a beneficiary, but only names children or grandchildren as the vested beneficiaries with perhaps a spouse as only a potential appointee may *not* be a related party under these narrower definitions as long as the taxpayer/spouse hold less than a remote contingent interest, even if the trust would be a related party under the broader definition in the two year rule of §453(e).[86]

Example: Bill and Cindy are planning to sell their LLC in a few years since their children have no interest in running the business. They sell a portion of it to a non-grantor trust for $5 million on a 20 year note, with interest only in early years while they plan to still receive an income. Unlike a sale to an IGT, the interest income is taxable to them (plus any hot assets associated with the sale which are not eligible for installment sale treatment), but their gain is deferred under installment sale rules. When the LLC is sold 3 years later, the trust incurs a small gain on the growth in the value of the company over the last 3 years, but its basis is the purchase price from three years prior (with modifications for later gains/distributions, etc.). Bill and Cindy still defer their tax on the gain as the installment payments are made.

Exploitation of Small Business Stock Capital Gains Exclusion

For taxpayers holding eligible C corporation stock for at least five years, there is a tremendous tax benefit that allows exclusion of 50%, 75% or more recently even *100% of the capital gains* from the sale.[87] There is a cap on the gain that can be excluded, $10 million or ten times basis.[88] What's a poor decamillionaire with more than $10 million of low basis stock to do?

Similar to Section 199A, Section 1202 has no related party rule applying this cap to an aggregate of related parties. Because the holding period will be tacked for gifts, there is no reason to believe that additional $10 million caps would not also be available to a *SLANT*, provided the sale would otherwise qualify for the exclusion.[89]

Unique and Challenging Issues with Family Use Residences/Toys in *SLANTs*

Gifting a personal residence or vacation home (or other personal use assets such as boats, art etc.) presents several challenging issues for *SLANTs*. While the trust is a non-grantor trust (either fully or partially as to principal), it will not qualify for the $250,000/$500,000 capital gains tax exclusion for sales of primary residences.[90] Thus, there should be an exit strategy to switch to grantor trust status well prior to any sale if there is substantial gain to meet the two of five year rule.[91] There may also be title insurance issues, homeowner's and property insurance issues and loan covenant issues if there is still a mortgage.[92] Gifting such property to a non-grantor trust is more viable if the loan can be paid off or refinanced in the name of the trust. Remember that any payment from a trust that reduces a settlor and/or spouse's debt would typically make the trust a grantor trust. In most states, non-recourse residential mortgages are rare to non-existent, but in some states non-recourse mortgages are actually mandated by state law.[93] It will depend on the locale, but transfers to an irrevocable trust may also cause a reassessment of property tax or loss of homestead property tax reduction.

Despite this complexity, there could be benefits. The deductibility of non-business property taxes are now severely restricted under the new $10,000 SALT limitation, whereas non-grantor trusts get a new bite at the apple.[94] For larger residences, tax reform also restricted the deductibility of mortgage interest.[95] Non-grantor trusts can receive the mortgage interest deduction, provided the residence is a qualified residence of a beneficiary who has a present or residuary interest in the trust, and this would likely be worth more than the SALT deduction.[96]

Would a spouse's (or potentially even the grantor's) use of such property cause estate inclusion and/or grantor trust status? Let's assume that there are no outstanding loans still on the property, or at least nothing owed by the grantor. Surprisingly, the grantor trust issues are even trickier than the estate/gift tax issues.

Spouses may be granted the use of residential property owned by a *SLAT* or *SLANT* without causing estate inclusion *or* an incomplete gift, *even if* the beneficiary-spouse permits the grantor-spouse to also use the property.[97]

The settlor may wish to spell out who pays real estate taxes and maintenance expenses for any non-rental residence. If the beneficiary pays the real estate taxes, the beneficiary gets the deduction, not the trust, and this would negate any chance to get an additional $10,000 SALT deduction by the trust against trust income from other assets.[98] Maintenance expenses on a trust-owned personal use residence would probably be nondeductible personal expenses whether the trust or the beneficiary pays for them.[99]

Would payment of such expenses be considered de facto distributions to the spouse (or other beneficiaries)? The mere use of property is not deemed to be a distribution for grantor trust purposes.[100] That said, there is one confusing and ill-reasoned case holding to the contrary.[101]

Even if the use of trust property is unlikely to be deemed a distribution, recall that IRC §674 is a grantor trust trigger that speaks to the grantor/spouse's "power to control beneficial enjoyment" of trust property. If the spouse has a power to exclude other beneficiaries from using trust property, this would likely trigger grantor trust status as to that property.[102] What about mere co-use? Because there is no clear line/rule in this regard, if wholly non-grantor trust status is sought, use of trust assets by a spouse should only be permitted with the consent of an adverse party or rented for fair market value.[103] In the case of a QTIP/SLANT, any terms would have to be the equivalent of an unrestricted life estate and already cause grantor trust status as to the accounting income (including any expenses attributed to accounting income).[104]

In summary, the various issues involved in gifting personal use assets such as residences to *SLANTs* can be quite hairy, and the benefits are usually not as compelling. Few would pay an attorney thousands of dollars (not to mention any accountant or trustee fees) to establish a uniquely drafted, cutting edge trust just for an additional $10,000 real estate tax deduction. If

additional mortgage interest on up to $750,000 acquisition indebtedness could be deducted it would be more compelling, but obtaining non-recourse financing for the trust may be difficult (probably impossible unless considerable other assets were contributed).

More importantly, even if the trust is immaculately drafted and adverse party consent documented, it is always possible that the continued use of such assets would be seen as *de facto* donor/spouse control, causing grantor trust status.[105] This is a much greater risk for residences where the use stays exactly the same after as before the transfer, than for other assets that may not pay any income to the spouse or only sporadically do so and/or pay to other beneficiaries as well.

Unique and Challenging Issues in Funding Leveraged Partnerships (LP/LLCs)

Ever since Rev. Rul. 85-13, practitioners have felt comfortable transferring and selling various assets from the grantor to irrevocable grantor trusts without any income tax effect. Many practitioners have never even transferred a closely held business to a non-grantor trust. Thus, it would be easy to miss an important landmine when the asset transferred is a leveraged partnership, which would be highly common for investments in real estate. The reason is that gain can be triggered upon gifting to another taxpayer to the extent any debt relief exceeds the basis, as well as if such an asset were already in a grantor trust and the trust changed status to a non-grantor trust.[106]

This is a great opportunity to work with the client's (and potentially their business') accountant to look out for negative capital accounts (a,k.a. "negative basis") and cases where the owner's share of debt exceeds their basis in the partnership (LP/LLC). [107]

Changing Grantor/Non-Grantor Trust Status and "Toggling"

What if a couple want to get out of the partial or fully non-grantor trust status years later and convert to the different advantages of a fully grantor trust? As a general rule, the IRS takes the position that conversion of a non-grantor trust to a grantor trust is not a taxable event, more analogous to a gratuitous transfer with carry over basis than a sale or exchange.[108] It has permitted modifications to change to grantor trust status.[109]

While going back and forth is not usually a taxable event (with the exception to this being the leveraged partnership issue discussed in the

section above), the IRS has indicated that it may question “toggling” back and forth between statuses as potentially abusive, and in narrow instances this is even reportable as a “transaction of interest”.[110] However, the import of that IRS Notice to toggling is misunderstood, exaggerated and overblown - the two instances of reportable transactions of interest mentioned in the Notice should not apply in our typical *SLANT* scenario, unless you’re also doing complex offsetting options and/or purchasing and sale of remainder and income interests – it’s the latter that was creating the abuse in the Notice.[111]

Avoiding the One-Year Rule of IRC §1014(e) if Spouse Dies Shortly After Gift

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 soon thereafter, even within one year of the transfer? Surprisingly, the answer is probably “yes”.[112]

Reciprocal Trust Doctrine Applied for *Income* Tax Purposes

Just as reciprocal trusts might be uncrossed for estate/gift tax purposes, they might also be for income tax purposes.[113] However, even if the settlors were uncrossed, a *SLANT’s* avoidance of settlor/spouse powers, and adverse party consent to use and receive distributions described herein should avoid tainting the trust, with one potential exception. Should the uncrossing unlock access to a settlor’s (or deemed settlor’s) creditors, this could cause grantor trust status through the back door. While common law and many states would only permit access to the maximum that a trustee could distribute in its discretion to a settlor (thus, no worry for a SLANT which requires adverse party consent), the Uniform Trust Code has an arguably wider net that may provide access even to trusts that require adverse party consent or even to trusts that only grant non-fiduciary powers to appoint to a deemed settlor.[114] Thus, if spouses intend to do planning that might invoke this doctrine, especially in UTC states that have not clarified their statute, it may be wise to use a self-settled domestic asset protection trust statute (similar to how some attorneys recommend the same for SLATs).

If the Donee/Beneficiary Spouse Dies First

Aside from a divorce, the other circumstance that might thwart access to the trust funds by the settlor indirectly via spouse would be the beneficiary-spouse predeceasing the settlor-spouse. As mentioned previously, a reversion is a grantor trust trigger. This would include a testamentary power of appointment held by the spouse enabling appointment to the grantor.[115] However, if the appointment is made with consent of adverse parties, or more likely to a trust under which distributions are made to the grantor only with consent of adverse parties, this would *not* be a grantor trust trigger.

So, what are the various income tax, estate tax and asset protection effects if the donee/beneficiary spouse of a *SLANT* were to appoint to a trust at death, such as an A/B trust, that may benefit the *settlor*-spouse?

The latter two issues intersect – any flaw in asset protection potentially causes estate inclusion. The problem with any intervivos trust (be it a QTIP or SLAT or SLANT) is that, after the death of the donee spouse, if assets come back to the donor spouse in trust, not just through a reversion but also through the exercise of a testamentary limited power of appointment, under most state laws the donor spouse is still the settlor (unless, perhaps, it is pursuant to a testamentary *general* power of appointment), making the trust self-settled and therefore subject to the donor's creditors despite any discretionary standard or spendthrift provision.[116] This asset protection flaw could cause inclusion in the donor spouse's estate indirectly under IRC §2041, since the ability to relegate to creditors would effectively be a general power of appointment.[117] Even though estate tax law deems the donee-spouse the grantor/transferor of an intervivos QTIP for §2036/2038 purposes, there is no specific analogous exclusion of application for §2041.[118] Many states have recently fixed this issue by statute. Some states only fixed the issue for marital deduction trusts (QTIPs and marital GPOA trusts), but some state statutes such as Arizona included protection for SLATs and SLANTs that do not elect the marital deduction.[119]

In addition to the 17 states listed in the footnote above, there are an increasing number of states (now also 17) with self-settled domestic asset protection trust (DAPT) statutes that effectively provide the same protection if the various criteria for coming under those statutes are met (e.g., in many cases, the settlor cannot be sole trustee or distribution advisor, but must appoint a qualified trustee).[120] Coming under these statutes may have other beneficial features even if the settlor is not a beneficiary.[121]

Thus, one should either establish a trust in one of the above-mentioned jurisdictions at the outset, or ensure that the spouse's exercise of the testamentary power of appointment changes the trustee/situs to one of the more protective jurisdictions, or ensure that the settlor is a mere permissive appointee rather than a beneficiary of the trust after the donee spouse's death. While there are still some open questions surrounding conflict of law analysis, the family would at a minimum have a better chance of having the out of state law honored here than for typical self-settled DAPT situations, and it's very possible the statute of limitations on allegations of the original transfer being fraudulent would have long passed.

What about the income tax effect? If the grantor retains or is granted certain rights or powers after the beneficiary-spouse's death, whether through exercise of a limited power of appointment or not, the trust might change to a grantor trust. To the extent the spouse exercises a testamentary *general* power of appointment, however, it will change the deemed grantor for income tax purposes, in which case the original settlor could retain significant rights and powers without causing grantor trust status.[122]

Exit Strategies

As with any QTIP or other trust, the spouse's interest can be terminated or vested outright through a qualified disclaimer, non-qualified disclaimer or release of their interest in the trust, or the adverse party powerholders may appoint the assets to them and terminate the trust.

A qualified disclaimer would have to be done within 9 months of the gift, unless the spouse is under age 21, in which case the spouse would have until 9 months after reaching age 21.[123] Remember, even though we think that the effect of a disclaimer must be the same as the effect if the disclaimant had predeceased, it does not have to be. The terms of the trust may provide for diverging dispositions between the two events – at death the proceeds may stay in trust for children and upon disclaimer the trust could even by its terms go back to the settlor.[124]

A non-qualified disclaimer or release would cause a taxable gift but could still be accomplished, even with a spendthrift provision.[125] If a non-qualified disclaimer or release were made over a trust in which a QTIP election were made, the gift would be valued as over the entire trust.[126]

The trustee could loan funds to settlor/spouse and still keep non-grantor trust status, *provided* the loan meets the more stringent requirements of having adequate interest (probably higher than A.F.R.) and adequate security, and being made by a trustee other than the grantor or related or subordinate trustee subservient to the grantor.[127]

Children or other beneficiaries who would qualify as "adverse parties" to the spouse may be granted the power to appoint to the spouse during the spouse's lifetime without offending either QTIP rules or grantor trust rules.[128] Any consent by an adverse party could be considered a taxable gift, but under most circumstances its value would be negligible.[129] Beneficiaries may be granted a power to appoint to the settlor-spouse of a QTIP, but *only after the donee spouse's death* (otherwise, this would violate the QTIP rule mandating that the spouse is the sole potential beneficiary during lifetime).

Beware of granting any additional trust protector or amendment clauses in the trust if they could be used in a way to disqualify a marital QTIP trust. The mere ability to amend would thwart qualification.[130] Decanting for such trusts should be limited in the document with an appropriate savings clause to preserve the eligibility for the election, even though state decanting statutes routinely carve out protections against changes that would endanger marital trusts.[131]

Entry **Strategies: Unique Issues When Decanting/Reforming an** ***Existing*** **IGT**

In contrast to establishing *SLANTs* through the use of lifetime gift tax exclusion, many clients may have existing completed gift irrevocable grantor trusts (IGTs) for which they'd wish to "turn off" grantor trust status and switch to a *SLANT* type status. As noted above, this is not usually a taxable event, but even if you can release powers or finagle a modification under the document or state law, beware that any IGT funded with *Crummey* provisions may not necessarily become a fully non-grantor trust after the grantor trust strings of IRC §§671-677 are cut, since the trust may then spring into a partially (or wholly) *beneficiary deemed owner trust* status under §678(a), unless the withdrawal power and any retained strings after partial lapse/release of the power holder and/or spouse thereof are also cut.[132]

GST Tax and Reverse-QTIP elections over Intervivos QTIP SLANTs

A donor-spouse can make a “reverse QTIP election” over an intervivos QTIP and allocate generation skipping transfer (GST) tax exemption.[133] This election means that for GST purposes it can be treated as if the QTIP election had not been made and the donor-spouse is considered the donor for GST purposes. With an ordinary QTIP without the reverse QTIP election, the *donee spouse* would be considered the transferor for GST purposes at the donee spouse’s death.[134]

Whether one should make the reverse QTIP election depends on several factors – primarily, is the trust likely to accumulate income and grow, which may indicate making a reverse QTIP in order to leverage GST exemption, or is it anticipated that significant distributions would be made or the trust even possibly terminated? QTIPs are inherently “leaky” due to the requirement to pay out all net income annually. Sometimes this GST exemption would be put to better use for a trust that would not be as leaky. If there’s a decent chance of later terminating the trust, GST should certainly not be wasted on its funding. However, it is good to keep this option on the table.

Contrasting *SLANTS* with *INGs*

Some fear that other states may try to emulate New York and pass legislation to combat the use of INGs, but this seems unlikely (four years hence no other state has sought to emulate New York, and the Multistate Tax Commission abandoned their attempt to address the issue). One has to consult each state statute and potentially case law to gauge whether there may be a difference for state income tax.

INGs have their advantages – they use no gift tax exclusion until the distribution committee orders distribution to parties other than the settlor/spouse, and there is no deemed gift by the distribution committee. The settlor retains more powers with an ING than a *SLANT*, principally the lifetime limited power of appointment (limited to ascertainable standards), testamentary limited power of appointment and consent power that are required to make the gift incomplete.[135]

These settlor control features may be a double-edged sword, however, making an ING inherently more susceptible to meeting the minimum contacts and nexus necessary for a state to tax a trust under the U.S. Constitution’s due process and commerce clause limits. Indeed, a recent Ohio Supreme Court case found that while a DING complied with all of

Ohio's statutory requirements to qualify as a non-resident trust, it was still subject to Ohio income tax on sale of corporate stock of an Ohio-sitused business due to the settlor's retained powers as manager of the business and as a resident settlor. Ohio would probably not have taxed such a sale under due process principles had a non-resident *individual* owned the stock.[136] There are many court cases finding state statutes violative of due process because of the minimal or non-existent trust contacts with the state, but it does not necessarily follow that courts in these same (or similar) states will conclude that *ING contacts* are so minimal (at least while the settlor still resides in state and retains such powers).[137] SLANTs would not have such settlor-retained powers and may be preferred in states such as Illinois and Michigan which have broad taxing statutes but have important case law recognizing Constitutional due process limitations where remaining trust contacts are at a minimum.

Some may find other aspects of INGs to be uncertain. For example, in a recent PLR the distribution committee that was ruled to be adverse consisted of many parties who were apparently not even remainder beneficiaries of the trust.[138] Are such parties truly adverse? Other PLRs had remainder beneficiaries as committee members. If *non*-adverse parties have discretion to pay income to a settlor and/or spouse the trust would be a grantor trust.[139] Two other recent ING PLRs ruled that the assets in the trust remained community property, even though we normally think of mere appointees under a power of appointment in a DAPT as having no property interest whatsoever.[140] While INGs are mostly on solid legal ground and remain a good option for the wealthy in certain states, some may find the additional advantages of *SLANTs* to be more compelling, especially since they can exploit the additional lifetime gift exclusion and be used for upstream planning.[141]

Another differentiating factor potentially favoring *SLANTs* is the requirement for those in most states to use out-of-state trustees located in a DAPT state, and the fear by some that negative debtor/creditor case law on out-of-state DAPTs could indirectly threaten non-grantor trust status.[142]

States Without a Trust Residency Trigger Based on Settlor/Beneficiary Residency

Some states will attempt to tax an irrevocable non-grantor trust based solely on the settlor's residency. Why these statutes may be

unconstitutional and the several cases so holding are discussed in a recent LISI article.[143] States with such statutes include Delaware, Illinois (which has contrary case law, see article), Maine, Maryland, Michigan (which also has case law, see article), Nebraska, Oklahoma, Pennsylvania (which also has case law, see article), Vermont, Virginia, Washington D.C., West Virginia and Wisconsin.

However, aside from these states there are quite a few states that will base their taxation of irrevocable non-grantor trusts based on the residency of the trustee and/or the situs of administration of the trust or governing law, factors that can easily be avoided for those in the highest tax bracket. These states include Arizona, Arkansas, Colorado, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Massachusetts, Mississippi, Montana, New Mexico, Oregon, South Carolina and Utah.[144]

There is a third group of states that incorporate several factors that are probably constitutional, that have multiple or overlapping required triggers based on the residency of the settlor and/or the residency of a beneficiary, such as Alabama, California, Connecticut, Missouri, North Dakota, North Carolina (although the *Kaestner* case was granted cert by the North Carolina Supreme Court and the law may change or be settled there shortly), Ohio, Rhode Island and Tennessee (though Tennessee is gradually phasing out its income tax and does not tax capital gains). These states' resident trust rules are difficult to avoid without paying very careful attention to who the beneficiaries are, their residency, the terms of their vesting and the distributions to them. California has a throwback rule that often allows deferral only until distributions to a California resident beneficiary. Connecticut allows avoidance, but only based on a fraction of non-resident to resident beneficiaries. Ohio has an altogether different concept that permits avoidance if distributions can't be made to Ohio residents in a given year.[145] In short, each state will have its own bespoke method of avoidance and may also have its own different quirks regarding source income, particularly for sales of intangibles such as LP/LLC interests.[146]

Conclusion – Don't Ignore State Income Tax and the New Federal Income Tax Advantages of Non-Grantor Trusts - Especially as the Estate Tax Advantages of Grantor Trusts Diminish in Importance

Residents of many states, including New York, as discussed in the companion newsletter, may be able to use intervivos non-grantor trusts

("*SLANTs*" if the trust includes a spouse) for superior income tax planning, both for state and federal tax purposes, especially those taxpayers in the highest tax brackets. These are not limited to someone willing and able to use a portion of their $11.18 million gift tax exclusion, but may include married couples establishing intervivos QTIPs, or those who may be able to convert existing completed gift *IGTs* to *SLANTs*.

SLANTs can often avoid state capital gains tax on sales of appreciated intangible assets. For ongoing business income, they usually cannot avoid state source income rules (unless the business is out of state), but may still be able to secure additional 20% deductions for qualified business income, an additional $10,000 of state and local tax deductions and better income tax shifting and charitable deductions. Such a design offers numerous asset protection and estate planning benefits as well.

While we shouldn't write off the estate tax (nor the irrevocable *grantor* trust) just yet, we should understand how to structure trusts to be as income-tax efficient as possible during lifetime and after death. Strategically structuring the form of transactions and ownership of assets may often avoid state and minimize federal *income* tax, while still accomplishing important non-tax estate planning goals. Estate tax planners are turning into estate and income tax planners. Recent tax reform has accelerated this trend.

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

Ed Morrow

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[1] No trademark claimed for the acronym. Ironically, *SLANT* has recently been the subject of one of the most important trademark (and free speech) Supreme Court decisions in decades. Simon Tam had attempted to federally trademark his Portland, Oregon-based rock band name, *The Slants*, but it was denied by the U.S. Patent and Trademark Office as a potentially disparaging term for those of Asian descent, even though he and his fellow band members were of Asian descent themselves and actively fighting such prejudice. Tam fought the USPTO all the way to the U.S. Supreme Court and won - unanimously. *Matal v. Tam*, http://www.scotusblog.com/case-files/cases/lee-v-tam/. Denial of the trademark was found to be a violation of free speech accorded by the First Amendment, which will have many more far-reaching consequences than this article. Some may prefer to use another acronym, such as a **s**pousal **l**ifetime **a**ccess **n**on-**g**rantor (*SLANG*) trust, or avoid shortcuts altogether and call it a plain vanilla "irrevocable non-grantor trust that happens to have a spouse as beneficiary or appointee" or "irrevocable non-defective trust". LISI contributor Martin Shenkman refers to such a trust as a "SALTy-SLAT", referencing the ability for such trusts to generate additional $10,000 state and local income tax deductions.

[2] Technically, the tax reform bill formerly referred to as the Tax Cuts and Jobs Act was passed into law with the formal title of "H.R.1 - An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." (Public Law 115-97). See https://www.congress.gov/bill/115th-congress/house-bill/1. This simplifies the name in the same way Congress simplified the tax code. I will refer to it by the shorter former name, or as simply "tax reform".

[3] For an example, see Uniform Probate Code §2-201 – §2-214.

[4] IRB 2018-10, Rev. Proc. 2018-18, §3.35: "Unified Credit Against Estate Tax. For an estate of any decedent dying in calendar year 2018, the basic exclusion amount is $11,180,000 for determining the amount of the unified credit against estate tax under § 2010." Absent new legislation and

assuming there is some inflation, this will be adjusted annually in subsequent revenue procedures.

[5] For a list of estate and GST tax reasons for intervivos QTIPs, see Chapter 30, Intervivos QTIP Trusts, of *Tools and Techniques of Estate Planning, 18th Edition*, by Stephan Leimberg, L. Paul Hood Jr., Martin Shenkman, Jay Katz and Edwin Morrow III.

[6] IRC §2523(f) and Treas. Reg. §25.2523(f)-1 are the main provisions, but these in turn will reference IRC §2056 and Treas. Reg. § 20.2056(b)-7(d)(1) and Treas. Reg. § 25.2523(e)-1(f) for further defining of a "qualifying income interest for life".

[7] IRC §2523(i), Treas. Reg. §25.2523(i)-1. While the marital deduction is *not* available for gifts to noncitizen spouses, a form of the gift tax annual exclusion is allowed for up to $100,000 (adjusted for inflation, for latest adjustments see Rev. Proc. 2016-55, §3.37, increasing it to $149,000). Unlike QDOTs, it is irrelevant whether a donee spouse becomes a citizen after the gift; gaining citizenship cannot cure or qualify the gift for the marital deduction retroactively. Treas. Reg. §25.2523(i)-1(d), Example 5.

[8] IRC § 2523(f)(4)(A) and Treas. Reg. § 25.2523(f)-1(b)(4) provide that the gift tax QTIP election must be made "on or before the date prescribed by section 6075(b) for filing a gift tax return with respect to the transfer (determined without regard to section 6019(2)) and shall be made in such manner as the Secretary shall by regulations prescribe." An extension to file income tax returns can extend the deadline for filing the gift tax return. If a return is filed without the election but the mistake is caught and a second return is filed on time the second filing will supersede the first. However, don't expect 9100 relief if your client misses the deadline altogether – the IRS has taken the position that it cannot extend this and that even 9100 relief is unavailable (similar to how the IRS will not grant 9100 relief to missed portability elections if the Form 706 was required by statute to be filed) - see PLR 2011-09012, which had revoked an earlier PLR that had allowed a 60-day extension. Also see *Estate of Nielsen*, 319 F.3d 1222 (10th Cir. 2003), in which an estate's attempt to claim there was no donative intent and void a gift after the intervivos QTIP election was missed was rejected.

[9] Usually determined under a state's version of the Uniform Principal and Income Act, if not otherwise addressed in the trust instrument, see IRC §643(b) and Treas. Reg. §25.2523(e)-1(f), which references its definition.

[10] Treas. Reg. §20.2056(b)-7(h), Example 1.

[11] Treas. Reg. §25.2523(e)-1(f)(7).

[12] Treas. Reg. §25.2523(f)-1(f), Example 5.

[13] Treas. Reg. §25.2523(e)-1(f)(4).

[14] Treas. Reg. §20.2056(b)-7(d)(6), IRC § 2056(b)(7)(B)(ii).

[15] IRC §2523(f)(5), Treas. Reg. § 25.2523(f)-1(d).

[16] IRC §671; Treas. Reg. §1.671-3(a). This is explored in more detail in *IRC Section 678(a)(1) and the "Beneficiary Deemed Owner Trust" (BDOT),* LISI Estate Planning Newsletter #2577 (September 5, 2017).

[17] One can still have a valid QTIP if distribution of income is not mandatory, but the spouse has the unfettered right to withdraw the same income. 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 Regulation 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." With such a design, §677 would likely still apply to the accounting income, since

the decision to distribute the income would be up to a non-adverse party (the donee spouse, via withdrawal right) and therefore trump any application of §678(a) during the grantor's lifetime. Regardless, there is no way to have the accounting income of an inter-vivos QTIP taxed under non-grantor trust rules of subparts A-D of subchapter J during the grantor's lifetime, which is the important point of this article. Using a §678(a) power over income in lieu of a distribution power can be extremely useful in many other instances however (see Ed Morrow, *IRC Section 678(a)(1) and the "Beneficiary Deemed Owner Trust" (BDOT)*, LISI Estate Planning Newsletter #2577 (September 5, 2017)).

[18] Treas. Reg. § 1.672(a)-1 Definition of adverse party.

> (a) Under section 672(a), an adverse party is defined as any person having a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust. A trustee is not an adverse party merely because of his interest as trustee. A person having a general power of appointment over the trust property is deemed to have a beneficial interest in the trust. An interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant.

[19] *Makransky v.Comm*., 321 F.2d 598 (3rd Cir. 1963), where grantor received assets only with consent of adverse party beneficiaries, held not grantor trust.

[20] Treas. Reg. §1.677(a)-1(g), Example 1:

> G creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671 through 677. Under the applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust has the following items of gross income and deductions:
>
> Dividends: $5,000
> Capital gain: $1,000
> Expenses allocable to income: $200

Expenses allocable to corpus: $100

Since G has a right to receive income he is treated as an owner of a portion of the trust under section 677. Accordingly, he should include the $5,000 of dividends, $200 income expense, and $100 corpus expense in the computation of his taxable income for 1970. **He should not include the $1,000 capital gain since that is not attributable to the portion of the trust that he owns. See § 1.671-3(b)**. **The tax consequences of the capital gain are governed by the provisions of subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Code**. Had the trust sustained a capital loss in any amount the loss would likewise not be included in the computation of G's taxable income, but would also be governed by the provisions of such subparts.

[21] We'll ignore ongoing capital gains passing through from pass through entities or mutual funds, which might default to being allocated to accounting income and therefore be part of DNI, and assume that the trust/trustee did not otherwise use one of the exceptions in Treas. Reg. §1.643(a)-3(b) that enable getting around the general rule that capital gains are not part of DNI.

[22] Treas. Reg. §1.671-3(c): "***On the other hand, if the grantor or another person is treated as an owner solely because of his interest in or power over ordinary income alone [note: when the grantor trust regulations refer to "*ordinary* income", they mean trust accounting income as described in Treas. Reg. § 1.643(b)-1, see Treas. Reg. §1.671-2(b)], he will take into account in computing his tax liability those items which would be included in computing the tax liability of a current income beneficiary, *including expenses allocable to corpus which enter into the computation of distributable net income*." See also the computation in example 1 in Treas. Reg. §1.677(a)-1(g).

[23] Treas. Reg. §1.677(a)-1(f) and (g), Ex. 2.

[24] Treas. Reg. §1.1361-1(k)(1), Example 10.

[25] Treas. Reg. § 1.672(a)-1(a): "A trustee is not an adverse party merely because of his interest as trustee.", *Estate of Towle v. Commissioner*, 54 T.C. 368 (1970)

[26] Treas. Reg. § 1.672(a)-1(a)

[27] *Holt v. U.S.*, 669 F. Supp. 751 (1987) (parents of settlor would only receive anything from trust if their grandchildren predeceased, a highly unlikely event, thus they were non-adverse); *Barker v. Comm.*, 25 T.C. 1230 (1956) (parents of settlor would only receive anything if their young son died before the age of 35 without a surviving spouse or issue, and they pegged the odds at 96-97% likely he'd live to age 35, thus non-adverse).

[28] PLR 2016-36031

[29] Treas. Reg. § 1.672(a)-1(b)

[30] PLRs 2013-10002 –10006, PLRs 2014-10001 -10010 (10 taxpayers), PLR 2014-26014, revoked by PLR 2016-42019 because of a somewhat hidden reversionary interest which caused grantor trust status not any adverse party issue, PLRs 2014-30003 –30007, PLR 2014-36008 -12, PLR 2014-40008 -12, PLR 2015-10001 – 2015-10008, PLR 2015-50005, PLR 2016-13007, PLRs 2016-36027 to 2016-36032, PLR 2017-29009. So, did the IRS simply fail to review Treas. Reg. 1.672(a)-1 or did they find that these committees were so obviously adverse and not impacted by the regulation that there was no need to cite it? I vote the former. That said, I think a committee can be adverse provided the majority of the members are also bona fide substantial beneficiaries with a property interest (with guardians for minors as acceptable substitutes).

[31] Treas. Reg. § 1.672(a)-1(d) "The interest of a remainderman is adverse to the exercise of any power over the corpus of a trust, but not to the exercise of a power over any income interest preceding his remainder. For example, if the grantor creates a trust which provides for income to be distributed to A for 10 years and then for the corpus to go to X if he is then living, a power exercisable by X to revest corpus in the grantor is a power exercisable by an adverse party; however, a power exercisable by X to distribute part or all of the ordinary income to the grantor may be a power exercisable by a nonadverse party (which would cause the ordinary income to be taxed to the grantor)."

[32] Treas. Reg. § 1.672(a)-1(b). "Thus, if A, B, C, and D are equal income beneficiaries of a trust and the grantor can revoke with A's consent, the grantor is treated as the owner of a portion which represents three-fourths

of the trust; and items of income, deduction, and credit attributable to that portion are included in determining the tax of the grantor."

[33] IRC §673.

[34] Treas. Reg. §1.671-3(b)(3).

[35] IRC §672(e).

[36] IRC §2037 is the estate tax provision. See Rev. Rul. 76-178 for instructions on valuations using IRC §7520 tables. While it would be rare, it's possible that a trust funded in year one is not a grantor trust, whereas when funds are added in year two it is, because of a change in §7520 rates. Similarly, a trust may appear to be excluded from estate tax upon creation, but a change in §7520 rates or other events could cause §2037 to be triggered at death.

[37] IRC §673(c).

[38] The trust could also include a similar lifetime power to appoint to the donor spouse, but this can only effective *after* the donee spouse's death, otherwise it would not qualify for QTIP marital deduction under §2523. The counterintuitive example of a limited power being w/consent of an adverse party while a general power need not be is due to the adverse party rules of Treas. Reg. §1.672(a)-1(c).

[39] Treas. Reg. §1.673(a)-1.

[40] *Restat 3d Property: Wills and Other Donative Transfers, § 25.2 Reversion or Remainder:* "A future interest is either a reversion or a remainder. A future interest is a reversion if it was retained by the transferor. A future interest is a remainder if it was created in a transferee."

[41] *Restat 3d Property: Wills and Other Donative Transfers, § 17.2*.

[42] Practitioners generally divide between the early "DING" PLRs: 2001-48028, 2002-47013, 2005-02014, 2006-12002,2006-37025, 2006-47001, 2007-15005, 2007-29025, 2007-31019 and those issued after IRS News Release IR-2007-127, enactment and repeal of IRC §2511(c) and IRS CCA Memo 2012-08-026: PLRs 2013-10002 to 2013-10006, PLRs 2014-10001 to 2014-10010, PLR 2014-26014, PLRs 2014-30003 to 2014-30007, PLRs 2014-36008 to 2014-36012, PLRs 2014-40008 to 2014-40012, PLRs 2015-

10001 to 2015-10008, PLR 2015-50005, PLR 2016-13007, PLRs 2016-36027 to 2016-36032, PLR 2016-42019 (I will refer to the latter collectively as the "post-2012 DING PLRs"). I refer to the "Delaware" version of the acronym for convenience and because it has a longer history of use. Practitioners have an increasing number of states that have good DAPT statutes that can be used – Ohio for instance has an excellent statute which has several procedural and substantive bars against creditors piercing trusts and an 18 month statute of limitations, but states with longer statutes of limitations to contest fraudulent transfers, such as Alaska, Delaware, South Dakota and Nevada, can also be used.

[43] IRC § 674(a).

[44] IRC §674(b)(4).

[45] IRC 674(c).

[46] This §675(4) swap provision understandably became much more popular after the IRS clarified that such powers would not normally cause estate tax inclusion. See Rev. Rul. 2008-22 and Rev. Rul. 2011-28 and discussion at *Ed Morrow On the Dark Side to Swap Powers in Irrevocable Grantor Trusts*, LISI Asset Protection Planning Newsletter # 313.

[47] IRC §675.

[48] Treas. Reg. §1.676(a)-1.

[49] See also Treas. Reg. §1.675-1(a) "If a grantor retains a power to amend the administrative provisions of a trust instrument which is broad enough to permit an amendment causing the grantor to be treated as the owner of a portion of the trust under section 675, he will be treated as the owner of the portion from its inception." While this provision does not expressly include non-adverse party powers to amend, one must be careful to avoid any implication of de facto alter ego control, as shown by the cases in footnote 52 below.

[50] See *Steve Oshins on the Completed Gift Hybrid DAPT as the Most Important Estate Planning Tool in an Estate Tax Reform Era,* LISI Estate Planning Newsletter #2511 (February 1, 2017)

[51] *IRC Section 678(a)(1) and the "Beneficiary Deemed Owner Trust" (BDOT*), LISI Estate Planning Newsletter #2577 (September 5, 2017).

[52] For more detail on exploiting the tax advantages of non-grantor trust status, see Part VIII, k and m. of the white paper the Optimal Basis and Income Tax Efficiency Trust, available for download at http://ssrn.com/abstract=2436964.

[53] If allowed, this permits gifts by one spouse to be considered as being made ½ by each spouse (provided neither are non-resident aliens). Both spouses must consent. See IRC §2513.

[54] See Rev. Rul. 56-439, which concludes that it is unavailable if the donee spouse's interest "is not susceptible of determination" (i.e., most discretionary trusts). For the most recent PLR on gift splitting in such situations, see PLR 2017-24007: Wife had created a SLAT for her husband and their descendants, granting the trustee the discretion to distribute income and principal to Husband for his "comfort, welfare, and best interests", both during her lifetime and after. While the IRS concluded that gift-splitting should not have been available, they admitted they were foreclosed from contesting it because the statute of limitations had passed.

[55] IRC §2513(a)(1).

[56] The Delaware Tax Trap is the colloquial name for IRC §2514(d) and IRC §2041(a)(3), which treats the exercise of a testamentary *limited* power of appointment similar to a general power of appointment in certain circumstances. IRC §2513 only references the definition of a general power in §2514(c), rather than the unique application described in §2514(d). For extensive discussion and comparison of using the Delaware tax trap v. formula general powers of appointment, see the white paper *The Optimal Basis Increase Trust*, available at www.ssrn.com. Also, see *Delaware Tax Trap Opens the Door to Higher Basis for Trust Assets*, Estate Planning Vol. 41, #2, Feb 2014 and *USRAP Surprise Trigger of Delaware Tax Trap*, 43 Est. Plan. 22 (2016) both by Les Raatz.

[57] PLR 8839008, in which the IRS ruled such a premium payment caused at least partial grantor trust status in the year the income from the trust was used to pay premium payments.

[58] *SEC v. Wyly*, 56 F. Supp. 3d 394 (S.D.N.Y. 2014), *Du Bois v Commissioner*, TC Memo 1986-160 (1986), *Webber v. Commissioner*, 144 T.C. No. 17 (2015) (*Webber* was not a grantor trust case, but an investor

control case concerning private placement life insurance, but some of the concerns are similar).

[59] IRC §675(3); *Bennett v. Commissioner*, 79 T.C. 470 (1982) (a loan by trust to a partnership in which grantor was partner caused grantor trust status).

[60] Rev. Rul. 85-13.

[61] *Estate of Atkinson v. Comm.*, 309 F.3d 1290 (11th Cir. 2002). See discussion of trust-piercing cases in *Ed Morrow: Asset Protection Dangers When a Beneficiary Is Sole Trustee and Piercing the Third Party, Beneficiary-Controlled, Irrevocable Trust,* LISI Asset Protection Planning Newsletter #339 (March 9, 2017).

[62] IRC §1361(c)(2), assuming the spouse is a U.S. citizen or resident.

[63] IRC §1361(c)(2)(A)(5) (ESBT) and IRC §1361(d) (QSST). The trustee makes the ESBT election, the beneficiary makes the QSST election. A few states will require a separate state ESBT election, e.g., New Jersey's Form NJ-1041SB.

[64] IRC §1361(d)(1).

[65] Treas. Reg. §1.1361-1(j)(2)(vi) and §1.1361-1(j)(4), Treas. Reg. § 1.1361-1(k)(1), Example (10)(iii).

[66] Treas. Reg. §1.1361-1(m)(2)(v), Treas. Reg. §1.1361-1(m)(8), Examples 3 and 4, Treas. Reg. §1.641(c)-1(c), Treas. Reg. §1.641(c)-1(l)(1), Example 1 includes comprehensive example of tax reporting for partial grantor trust ESBT.

[67] Treas. Reg. §1.1361-1(m)(5)(ii), Treas. Reg. § 1.641(c)-1.

[68] See Section 13541. EXPANSION OF QUALIFYING BENEFICIARIES OF AN ELECTING SMALL BUSINESS TRUST of "H.R.1 - An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

[69] IRC §199A, contained in Section 11011 DEDUCTION FOR QUALIFIED BUSINESS INCOME of "H.R.1 - An Act to provide for reconciliation

pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

[70] There is one instance where the two are considered together for purposes of apportioning the W-2 wages between a trust/estate and a beneficiary at IRC §199A(f)(B), but that's not the same as applying one cap to multiple related parties. Trusts and estates receive a separate $157,500 threshold with phase out from $157,500 to $207,500 – once above the latter amount the deduction would either be eliminated for specified services businesses or be subject to further testing and potential limitations of the greater of 50% of W-2 wages or 25% of W-2 wages plus the unadjusted basis of qualified property for other businesses.

[71] See *Mattie K. Carter Trust v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003)* and *Frank Aragona Trust v. Comm.*, 142 T.C. No. 9 (Mar. 27, 2014), both of which are trust taxpayer-friendly cases on this issue. But for the IRS' contrary restrictive interpretation of when a trustee can materially participate, see TAM 2013-17010 and prior to that, TAM 2007-33023. Expect more on this issue in coming years.

[72] IRC §663(b).

[73] IRC §641(c). See tax reform act, SEC. 13542. CHARITABLE CONTRIBUTION DEDUCTION FOR ELECTING SMALL BUSINESS TRUSTS

[74] IRC §643(f): "Treatment of multiple trusts. For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if—

> (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and
> (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.
> For purposes of the preceding sentence, a husband and wife shall be treated as 1 person."

Note: this last sentence of §643(f) may be a concern aside from the reciprocal trust doctrine enunciated in *Grace* usually applicable in the estate/gift tax arena to combat reciprocal *SLANTs* from an income tax perspective. However, what should we make of the seeming requirement "*under regulations prescribed by the Secretary"* – what if there are none, as

in this case? Does the statute have no effect until Treasury enacts a regulation?
There is an old pre-§643(f) regulation on this subject on the books that was found to be unconstitutional in *Edward L. Stephenson Trust v. Comm*., 81 T.C. 283 (1983), but §643(f) was added to the code shortly after this regulation and case, in Public Law 98-369, § 82(a) (July 18, 1984): Treas. Reg. §1.641(a)-0(c), which was struck down, states:

> "(c) Multiple trusts. Multiple trusts that have:
> (1) No substantially independent purposes (such as independent dispositive purposes),
> (2) The same grantor and substantially the same beneficiary, and
> (3) The avoidance or mitigation of (i) the progressive rates of tax (including mitigation as a result of deferral of tax) or (ii) the minimum tax for tax preferences imposed by section 56 as their principal purpose,
> shall be consolidated and treated as one trust for the purposes of subchapter J."

So, would this regulation that was unconstitutional when enacted, which would now be a reasonable and Constitutionally valid interpretation of §643(f) if enacted today, now be effective? There is an argument that §643(f) requires a regulation be enacted AFTER the statute, and clearly address the statute (after all, the regulation above is not numbered e.g., §1.643(f)-1). However, for planning purposes, it is probably more prudent to simply assume the above regulation applies, since complying is not difficult and would thwart other avenues of attack such as substance over form.

[75] February 7, 2018 Department of the Treasury 2017-2018 Priority Guidance Plan available at: https://www.irs.gov/pub/irs-utl/2017-2018_pgp_2nd_quarter_update.pdf: "7. Computational, definitional, and anti-avoidance guidance under new §199A."

[76] For discussion of the 6th Circuit Summa Holdings case, see LISI articles *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 and Retirement Planning #670 (March 16, 2017) (this article focuses more on substance over form issues); *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 and Retirement Planning #672 (March 23, 2017) (this article focuses more on prohibited transaction issues). The First Circuit recently independently upheld the 6th Circuit on the same facts and situation with a different taxpayer as party in Benenson v. Comm.

[77] IRC §7701(o)(5)(B) – the "transaction" to be ignored would be the transfer to the trust, which should be a "personal transactions of individuals" exception.

[78] See Gerald Snow, *Problem Areas Under Internal Revenue Code Section 704(e): The Family Partnership Revisited,* 3 BYU J. Pub. L. 29 (1989).

[79] Treas. Reg. 1.704-1(e)(iv).

[80] *Family Partnership Rules of Code Sec. 704(e) and New Code Sec. 199A*, by Martin M. Shenkman, Jonathan G. Blattmachr, Alan Gassman and Joy Matak, Estate Planning Review – The Journal. I commend the article as the best summary of these core issues in light of tax reform.

[81] E.g. North Dakota's top rate, though low, is very compressed for trusts and estates and starts at only $12,300 v. $411,500 for individuals. Vermont is similar, with their 8.95% top rate starting at $12,300 for trusts v. $411,500 for individuals. Rhode Island is similarly compressed, the top rate starting at only $7,700 for trusts and estates.

[82] According to a 2001 ACTEC study comparing state trust taxation schemes (https://www.actec.org/assets/1/6/Study6.pdf), states that start with a trust's federal taxable income are Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Hawaii, Idaho, Illinois, Indiana, Kansas, Maine, Maryland, Michigan, Minnesota, Missouri, Nebraska, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, Rhode Island, South Carolina, Utah, Vermont, Virginia, West Virginia and Wisconsin. Please note that this chart has not been updated since 2001. For example, Ohio would now also be on that list of states that start with a trust's taxable income.

[83] See IRC §453. It's beyond the scope of this article to detail this, but exceptions to installment sale treatment include "hot assets" or depreciation recapture under §453(i), marketable securities under §453(k)(2), dealer dispositions or inventory dispositions under §453(b)(2), which might include

real property (that is not farm property) if held for sale to customers in ordinary course of business. For obligations exceeding $5 million (which ceiling may be double if married, or, again if you're following the theme of this article, perhaps more with the judicious use of non-grantor trusts as separate taxpayers), IRC §453A provides for interest to be paid on the deferred tax liability.

[84] IRC § 453(e). There is a provision to avoid the two-year rule in rare cases – it is not applied "if it is established to the satisfaction of the Secretary that neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of Federal income tax" under IRC §453(e)(7), but this is hardly useful for any proactive planning.

[85] IRC §1239(b)(2) and IRC §453(g)(3), which incorporates the related party rule of §1239(b).

[86] "Remote contingent interest" is similar to the reversionary rules of IRC §2037 and IRC §673 discussed elsewhere herein and is defined in §318(a)(3)(B)(i) "For purposes of this clause, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property". Thus, as we discussed in the section on §673, we must calculate using the maximum exercise of discretion by the trustee – in a typical ING or SLANT, there would be no discretion in the trustee to distribute to grantor/spouse.

[87] IRC § 1202. The % exclusion, if eligible, depends on the year of acquisition. After September 27, 2010, it would be 100%, but between August 10, 1993 and September 27, 2010, it would be a 50% or 75% exclusion.

[88] IRC § 1202(b)(1).

[89] IRC §1202(h).

[90] Treas. Reg. §1.121-1(c)(3).

[91] IRC § 121(a) requires a home to be owned and used as a principal residence for two of the last five years. The House version of tax reform

would have severely limited this exclusion, but changes were jettisoned in the final version of the bill.

[92] E.g. the Garn St. Germaine Act, 12 U.S.C. § 1701j-3(d)(8), contains federal law preemptions on due-on-sale clauses and exempts some but not all transfers to trust from triggering loan convenants: "(8) a transfer into an inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property". Regulation 12 C.F.R. §591.5(b)(1)(vi) further provides an exception for "(vi) A transfer into an inter vivos trust in which the borrower is and remains the beneficiary and occupant of the property, unless, as a condition precedent to such transfer, the borrower refuses to provide the lender with reasonable means acceptable to the lender by which the lender will be assured of timely notice of any subsequent transfer of the beneficial interest or change in occupancy." This of course begs the question as to whether a spouse only residing with permission of an adverse party would be considered a beneficiary and occupant for this purpose; arguably there is a transfer of rights of occupancy. The safest route would be to confirm the intended transfer with the lender.

[93] See the 2011 compiled 50 state survey COMPARISON OF STATE LAWS ON MORTGAGE DEFICIENCIES AND REDEMPTION PERIODS, which includes statutory cites at https://www.cga.ct.gov/2010/rpt/2010-R-0327.htm. I did not independently verify, but these states were cited as residential mortgage non-recourse states as of December 2011: Alaska, Arizona, California, Hawaii, Minnesota, Montana, Nevada, North Dakota, Oklahoma, Oregon, and Washington.

[94] Taxes paid or accrued in carrying on a trade or business are not subject to the new $10,000/$5,000 limitation. See Section 11042 of the Act. Whether renting real estate is a trade or business will be a hot topic in future years – most probably will be, but what about triple net leases, etc.? Perhaps the income from such property is not trade or business income, in which case it may merit different consideration.

[95] SEC. 11043. LIMITATION ON DEDUCTION FOR QUALIFIED RESIDENCE INTEREST of the Act modifies IRC §163(h)(3) for tax years 2018-2025, restricting the home equity indebtedness interest deduction and instead of permitting acquisition indebtedness interest of up to $1,000,000/$500,000 (MFS), it is reduced to $750,000/$375,000 for

purchases after December 15, 2017. So, for the couple purchasing a $2 million home w/$1.5 million debt in 2018-2025, could it make sense for a *SLANT* to purchase 50% of the property?

[96] IRC §163(h)(4)(D) "Special rules for estates and trusts

For purposes of determining whether any interest paid or accrued by an estate or trust is qualified residence interest, any residence held by such estate or trust shall be treated as a qualified residence of such estate or trust if such estate or trust establishes that such residence is a qualified residence of a beneficiary who has a present interest in such estate or trust or an interest in the residuary of such estate or trust."

[97] Practitioners may fear that gifting a residence in trust for a spouse would inevitably trigger retained interest §2036 concerns, since the grantor-spouse might use the property, making the gift incomplete, causing estate inclusion and/or impairing asset protection. This is a rational fear, and explicit or implied agreements for the grantor to continue to use any transferred property should be avoided. However, using the property as a guest of the beneficiary-spouse is simply a by-product of the marital relationship and does **not** cause estate inclusion by itself, see *Union Planters National Bank v. United States*, 361 F.2d 662 (6th Cir. 1966), *Gutchess v. Comm.*, 46 T.C. 554 (1966), *acq*. 1967-1 C.B. 2, Rev. Rul. 70-155, see also PLR 2002-40020.

[98] *Horsford v. Comm.*, 2 T.C. 826 (1943), *Cummings v. Comm.*, T.C. Memo 1949-1666, *Estate of Movius v. Comm.*, 22 T.C. 391 (1954).

[99] *Alfred I. DuPont Testamentary Trust v. Comm.*, 514 F 2d 917 (5th Cir 1975)

[100] Use by a U.S. beneficiary of a foreign trust would be, under IRC §643(i), but this is the exception to the rule – the use of property is not generally a distribution for U.S. trusts, see *Alfred I. DuPont Testamentary Trust v. Comm.*, 66 TC 761 (1976), aff'd 574 F 2d 1332 (5th Cir 1978), which cited *Commissioner v. Plant*, 76 F.2d 8 (2d Cir. 1935), acq. 1976-1 C.B. 1; see also TAM 8341005.

[101] *Moreell v. U.S.*, 221 F. Supp. 864 (D.C. Pa. 1963), holding that the trust could deduct the greater of FMV rent or the aggregate expenses paid up to

DNI, making them taxable to the beneficiary. This case is a confusing outlier, for contrary cases and ruling, see the citations in footnote 90 above.

[102] Treas. Reg. §1.674(a)-1. It's not especially clear, however. There are cases where rent-free use of property was tangentially cited as a point when finding grantor trust status, but these are sham/"constitutional" trust cases with plenty of more egregious facts. See, e.g. *Wesenberg v. Comm.*, 69 T.C. 2005 (1978)

[103] See IRC §280A for unique income tax rules regarding rental of personal residences. There could be other many issues with renting the property as well and this would likely not be a palatable solution for most.

[104] Thus, if a settlor of a QTIP/SLANT desired for the trust to deduct up to $10,000 of real estate taxes or mortgage interest, the trust/trustee would have to allocate such expenses to principal. The default is typically to allocate such expenses to income, so the document would have to apportion otherwise or grant the trustee the authority to apportion otherwise, see the Uniform Principal and Income Act. There would, of course, need to be sufficient income allocated to principal for the deductions to offset, which might also require some deviation from default UPIA rules.

[105] *SEC v. Wyly*, 56 F. Supp. 3d 394 (S.D.N.Y. 2014), concerned a wealthy family who used Isle of Man trusts (even with independent trustees) to purchase personal use assets for their homes in Texas (and perhaps do some insider trading on the side). The trust instrument was not defective and did not cause grantor trust status, the administration and settlor use did. While they exerted indirect control in many ways that probably implicated several grantor trust statutes, the case was actually decided under a §674 analysis. *Wyly* is certainly a "bad facts" case, but the continued use of a residence, even with adverse party consent, skirts perilously close to being "bad facts" despite black letter compliance with the grantor trust rules.

[106] Treas. Reg. §1.1001-2(c), Ex. 5 (providing grantor recognizes gain upon termination of grantor trust status equal to the excess of relief from partnership debt over the basis in his partnership interest). See also *Madorin v. Comm'r*, 84 T.C. 667 (1985) (upholding Ex. 5 in Treas. Reg. §1.1001-2(c)); Rev.Rul. 77-402, 1977-2 C.B. 222. Treas. Reg. 1.752-1(c) deems relief of debt to be a distribution.

[107] For some examples and explanation, see this online article from The Tax Advisor, Gifts of Partnership Interests, by Albert Ellentuck, available at https://www.thetaxadviser.com/issues/2016/apr/gifts-of-partnership-interests.html

[108] Rev. Rul. 85-13, Chief Counsel Advice 2009-23024.
[109] A trust was modified to include grantor trust powers (non-fiduciary 675(4) swap power) that were not originally in the trust in order to cause the trust to be a grantor trust in PLR 2008-48017.

[110] IRS Notice 2007-73.

[111] Frankly, it's the purchasing and sale of remainder and income/unitrust interests that created the abuse in IRS Notice 2007-73, not any toggling or grantor trust status by itself. The area of sale of income/remainder interests is ripe for exploitation (or abuse, depending on your perspective) because there is not the same clear inside/outside basis and *hot asset* rules for sales of trust interests as there is for partnerships. The identified transactions use the purported termination and subsequent re-creation of grantor trust status within a very short period of time (same tax year), coupled with sales and purchases of income/remainder interests, to allow the grantor either to claim a tax loss greater than any actual economic loss sustained by the taxpayer or to avoid inappropriately the recognition of gain. Don't use complicated option transactions, GRATs, springing swap powers, straw man buyers, purchases of income/remainder interests or toggle in the same tax year to achieve artificial step ups in basis and you're not close to Notice 2007-73. Instead of scaring practitioners by casting aspersions on innocent toggles, the IRS should apply partnership tax principles when unrelated parties enter into complicated trust transactions together for profit.

[112] Discussion of this point is beyond the scope of this article. See discussion in Chapter 30, *Intervivos QTIP Trusts*, of *Tools and Techniques of Estate Planning, 18th Edition*, by Stephan Leimberg, L. Paul Hood Jr., Martin Shenkman, Jay Katz and Edwin Morrow III. See also Part V.g *Using Intervivos QTIP Trusts to Avoid §1014(e) one year rule*, of the white paper *Optimal Basis Increase Trust*, by Edwin Morrow III available at www.ssrn.com.
[113] *Adolph K. Krause*, 57 T.C. 890, aff'd 497 F.2d 1109 (6th Cir. 1974).

[114] Uniform Trust Code §505(a)(2): “With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that ***can be distributed*** to or for the settlor’s benefit.” Note that *it does not say who*, whether it is a non-fiduciary power holder of a limited power of appointment, adverse party, trust protector etc., whereas *Restatement (Second) of Trusts §* 156“[w]here a person creates for his own benefit, a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which ***the trustee*** under the terms of the trust could pay to him or apply for his benefit.” In today’s environment this may be a crucial difference. This is why hybrid trusts with trust protectors who can add settlors to a trust still have an Achilles Heel in UTC states that have not clarified their statutes to be more protective (like Ohio).

[115] Treas. Reg. § 1.672(a)-1(c), copied in full in footnote 18 above.

[116] States may vary on this point, some may deem the entire trust accessible, some may deem only the maximum amount that may be distributed to the settlor to be accessible. E.g., Uniform Trust Code §505(a)(2): “With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor’s benefit.” See also *Restat. 2d Trusts* §156.

[117] This point is debatable and may be overblown, since IRC §2041(b)(1)(C) and §2514(c)(3)(A) exclude any power of appointment exercisable only in conjunction with the creator of the power, and there are specific regulations preventing inclusion under the string sections of §§2036/2038. The settlor’s indirect access to funds in a trust that is not protected from creditors would be a de facto presently exercisable general power of appointment if not for the likely application of §2514(c)(3)(A)). Thus, do not give up the argument if your client lives in a state that has neither a self-settled trust statute nor a statute similar to those listed in footnote 106 below (assuming you want to avoid estate inclusion). Regardless of estate tax ramifications, it’s an issue for asset protection purposes.

[118] IRC §2044(c), Treas. Reg. §25.2523(f)-1(f), Example 11.

[119] States that have recently fixed this issue are:
Arizona (Ariz. Rev. Stat. §14-10505(E))
Arkansas (Ark. Code Ann. §28-73-505(c))
Delaware (12 Del Code §3536(c)(1))

Florida (Fla Stat. §736.0505(3))
Kentucky (Ky. Rev. Stat. § 386B.5-020(8)(a)
Maryland – MD Est. & Trusts Code §14.5-1003(a)(2).
Michigan (MCL §700.7506(4))
New Hampshire (N.H. Rev. Stat. Ann. §564-B:5-505(a)(2)(d))
North Carolina (N.C. Gen Stat. § 36C-5-505(c))
Ohio (Ohio R.C. §5805.06(B)(3)(b))
Oregon (Or. Rev. Stat. § 130.315(4))
South Carolina (S.C. Code Ann. § 62-7-505(b)(2))
Tennessee (Tenn. Code Ann. §35-15-505(d))
Texas (Tex. Prop. Code §112.035(g))
Virginia (Va. Code §64.2-747(B)(3))
Wisconsin (Wisc. Stat. §701.0505(2)(e))
Wyoming (Wyo. Stat. Ann. § 4-10-506(e))

[120] See comparison chart of DAPT statutes and their features, compiled by ACTEC members under Alaska attorney David G. Shaftel as editor at: https://www.actec.org/assets/1/6/Shaftel-Comparison-of-the-Domestic-Asset-Protection-Trust-Statutes.pdf

[121] For example, even if a trust is not self-settled, DAPT statutes such as the Ohio Legacy Trust Act often have more favorable fraudulent transfer law associated therewith and better protection for beneficiary powers. E.g. Ohio R.C. §5816.07 and §5816.08.

[122] See Treas. Reg. §1.671-2(e)(5), Example 9.

[123] IRC §2518(b).

[124] Some readers may wonder whether this could create a reversion at common law and for §673 purposes. The spouse's disclaimer would be an "act of independent significance" in many areas of the law, such as the possibility of adding children as beneficiaries through procreation or adoption not triggering §2036/2038 (Rev. Rul. 80-255), or the possibility of divorce (which allows the floating spouse technique to be used unless a QTIP election is desired, *Estate of Tully*, 528 F.2d 1401 (1976); PLR 9141027). At first glance, such an alternative disposition upon disclaimer sounds a bit like a reversion under a broad definition, albeit the chance of it occurring is remote and temporary (9 months if the disclaimant is over 21). So even if it might be ignored for §2037 estate tax purposes, it is not crystal clear that it is for §673 grantor trust purposes, especially in light of PLR

2016-42019, discussed above. The question would be, under §673(c), would a disclaimant be exercising an "exercise of discretion", as PLR 2016-42019 so deemed the distribution committee's potential for resigning? Ultimately, the two actions/powers are meaningfully different. Unlike a distribution committee's power, a disclaimer is not an "exercise of discretion" (defined as "n. the power of a judge, public official or a private party (under authority given by contract, trust or will) to make decisions on various matters based on his/her opinion within general legal guidelines). A disclaimer is refusing to accept property. You can't be sued for exercising a disclaimer in bad faith and there are no guidelines granted in a trust document to a disclaimant to act within. If the IRS were to deem disclaimers to be acts of discretion it would lead to absurd results not intended by Congress, since there is always the remote possibility that all beneficiaries of any irrevocable trust disclaim, creating a resulting trust that reverts to the settlor. Such an absurd interpretation would mean all irrevocable trusts are grantor trusts under §673 for at least 9 months. Ergo, disclaimers are not in the same category as acts of discretion, and such a remote possibility of a reversion due to disclaimers would not trigger §673(c).

[125] See Restatement 3d, Trusts §58, comment c.

[126] Technically the gift would be valued in two parts – IRC §2511 would deem the spouse's income interest to be a gift and IRC §2519 would deem the rest of the trust property to be a gift. Sometimes this bifurcation can make a difference for annual exclusion qualification and gift tax apportionment, issues beyond the scope of this article.

[127] IRC §675(3).

[128] Treas. Reg. §25.2523(e)-1(f)(6).

[129] While it is debatable, the exercise of a limited lifetime power of appointment may be a taxable gift (though not of the whole amount) under the theory that the party is giving up a portion of their property rights. For those who are current beneficiaries, the principles behind this are discussed in Rev. Rul. 79-327, IRS TAM 9419007 and *Estate of Regester*, 83 T.C. 1 (1984), all of which found there to be a taxable gift over a portion when a beneficiary with a life estate (income interest) exercised a lifetime power of appointment. These authorities contrast with *Self v. United States*, 142 F. Supp. 939 (1956), which found to the contrary. If the power

holder is instead a vested remainderman, the conclusion is similar, see Treas. Reg. §25.2511-1(h)(6) "If A is possessed of a vested remainder interest in property, subject to being divested only in the event he should fail to survive one or more individuals or the happening of some other event, an irrevocable assignment of all or any part of his interest would result in a transfer includible for Federal gift tax purposes. See especially § 25.2512-5 for the valuation of an interest of this type." Calculating the value of these interests is not as simple when it is not "all net income to A, remainder to B". A typical trust where someone is going to continue protection for their children and/or grandchildren is not going to pay outright and would thus be worth much less. The IRS has acknowledged this in several PLRs but still maintains there is some value to a discretionary interest for gift tax purposes. See, e.g., PLR 8535020. To get around this altogether, grant the child the power to amend the trust (or a non-judicial settlement agreement may do so) to permit the trustee to distribute principal to the spouse without consent of an adverse party. Upon amendment, this would cause the trust to become a grantor trust (provided the trustee is nonadverse) and when the independent *trustee* thereafter distributes assets *unilaterally*, this may not cause the child to be deemed to have made any taxable gift since it is an independent act of the independent trustee that causes the distribution. The child's prior consent might be argued to be a gift, but this is at least highly debatable.

[130] 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.

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[131] “It is my intent that my contribution to this trust shall qualify for the federal gift tax marital deduction under IRC §2523 and no power or discretion may be exercised except in a manner consistent with this intent.”

[132] If there is a current withdrawal power, determining status is rather clear cut, but as regards to powers that were partially lapsed/released while the grantor’s powers trumped them, it’s anyone’s guess as to how §678(a) springs into action when the grantor trust powers that typically override §678(a) pursuant to IRC §678(b) are turned off (at death or otherwise). See PLR 9026036 and its arch nemesis doppelgänger PLR 9321050, which came to contrary conclusions. The IRS ruled in the former PLR that former withdrawal powers previously eclipsed by §678(b) spring into full effect, while they ruled in the latter PLR that the effects were essentially extinguished by §678(b) and only powers existing after the taint is removed are counted. While I think the 1990 PLR is probably better reasoned, it’s hardly clear cut and the more recent 1993 PLR would be a more favorable interpretation for someone seeking to change an existing IGT funded in part with prior Crummey gifting into a fully non-grantor trust on lifting the grantor’s §§671-677 taint. If it’s a lucrative enough case, ask the IRS for a PLR.

[133] IRC §2652(a)(3).

[134] Treas. Reg. §26.2652-2(d), Example 3.

[135] For general features of INGs, see *Bill Lipkind on PLR 2013-10002: DING Redux*, LISI Estate Planning Newsletter #2076 (March 12, 2013), *Eliminate State Tax on Trust Income: A Comprehensive Update on Planning with Incomplete Gift Non-Grantor Trusts,* by Kevin Ghassomian, ACTEC Law Journal, Winter 2013.

[136] *T. Ryan Legg Irrevocable Trust v. Testa*, 149 Ohio St.3d 376, 2016-Ohio-8418. By contrast, individuals selling such stock would not have been taxed under another recent Ohio Supreme Court case discussed in *Ed Morrow on Corrigan v. Testa and Avoiding State Income Tax on Source Income*, LISI Income Tax Planning Newsletter #93. Harmonizing these two cases into a coherent rule is difficult to say the least.

[137] See cases listed in *Ed Morrow on Fielding: Yet Another Case Where State Income Tax Against Out of State Trusts and Residents Ruled*

Unconstitutional, LISI Income Tax Planning Newsletter #117 (August 31, 2017).

[138] See short discussion of PLR 2017-29009 at https://www.linkedin.com/pulse/yet-another-ing-plr-charities-potential-edwin-morrow/.

[139] "Adverse" for grantor trust purposes is defined in IRC § 672(a) "Adverse party

> For purposes of this subpart, the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust."

I question whether someone who is a mere committee member/appointee, but not a beneficiary, has a property interest at all, much less a "substantial beneficial interest". If the distribution committee members had a general power, this would count under the 2nd sentence above, but of course one of the most important rulings in all the ING PLRs is that the distribution committee members do NOT have a general power of appointment, by virtue of the expiration of the joint holder's power upon death (a.k.a. shrinking committee structure), which is protected from being considered a general power of appointment by Treas. Reg. § 25.2514-3(b)(2).

[140] Kudos to the advocate(s) who obtained the rulings, I would not have given very good odds of receiving a positive response on the community property issue. PLR 2015-50005, PLRs 2016-53001 to 2016-53009, PLR 2017-44006.

[141] By "upstream planning" I am referring to the ability to grant an older beneficiary a testamentary general power of appointment up to their available applicable exclusion amount. If the gift to the trust is incomplete, the one year rule of IRC §1014(e) would apply to negate any step up in most cases just as it would if the power were held in a revocable trust, whereas a completed gift trust funded at least one year before a power holder's death would avoid this issue. See Part V of the Optimal Basis Increase Trust white paper at www.ssrn.com, or see "*The Upstream*

Crummey Optimal Basis Increase Trust", Morrow, Estate Planning Review – The Journal, May 22, 2014 issue.

[142] Recall that access by a settlor's creditors will cause grantor trust status under Treas. Reg. §1.677(a)-1(d). DAPTs are always recommended for INGs because of the general rule in most states that if a settlor is a beneficiary, creditors can reach the trust. In most of the PLRs and at least the INGs that I have seen the settlor is not a beneficiary but more aptly described as a potential appointee under a non-fiduciary limited power of appointment. Under common law, a settlor being a mere appointee does not trigger self-settled trust status, but UTC §505(a)(2) opens up a dangerous window for debate since it does not foreclose non-fiduciary powers to appoint to a settlor as triggering the rule, which some UTC states have foreclosed by clarification (e.g. Ohio R.C. §5805.06(B)(3)(a)). That said, attorneys understandably prefer to use a belt-and-suspenders approach and all ING PLRs have used DAPT statutes. There is a second equally important reason to use a DAPT that is often overlooked – whether the joint powerholders (donees) of the lifetime power of appointment could be considered GENERAL power holders under *state* law, thus subjecting the ING to a *power holder's* creditors. There is a clear federal regulation that prevents the shrinking committee structure of the ING from being a general power for federal estate/gift tax purposes under Treas. Reg. § 25.2514-3(b)(2). However, there is no reason to believe that state debtor/creditor law should follow federal tax law on this point. Think of the optics - you have a committee with the joint power to appoint all the trust assets to themselves! It sure smells like a general power and creditors would smell that blood in the water from a mile away. DAPT statutes, however, (at least in the statutes such as Ohio, Nevada, Delaware that I have reviewed) generally foreclose this line of attack. But it merely begs the question when a power holder is a debtor and resident of a non-DAPT state, whether a creditor could make a state law *Huber*-style attack on the assets using the applicable state law of the debtor or creditor or locus of the action rather than the law of the DAPT state. This may be a reason for some to consider SLANTs as a safer option to INGs. Some have expressed fear that the fraudulent transfer piercings of DAPTs in *Huber* and *Mortensen* and now *Wacker* threaten the non-grantor trust status of INGs. I do not share this fear – if the mere *possibility* of voiding a transfer to a trust on fraudulent transfer grounds made a trust a grantor trust, this would automatically make *every* trust a grantor trust until the statute of limitations ran out, and even this would be hard to discern, since it may be

ten years or longer depending on the court and circumstances. The IRS would more likely adopt a more reasoned approach to avoid such absurdity, such as that used in Treas. Reg. §25.2518-1(c) on disclaimers – the mere possibility of a disclaimer being voided under fraudulent transfer law does not disqualify it, but the *actual* voiding of it would. This would be a logical view for grantor trust purposes as well – if a settlor's creditors pierce the trust on fraudulent transfer grounds it causes grantor trust status, but not until then.

[143] *Ed Morrow on Fielding: Yet Another Case Where State Income Tax Against Out of State Trusts and Residents Ruled Unconstitutional*, LISI Income Tax Planning Newsletter #117 (August 31, 2017).

[144] For unique aspects of Utah law, see *Ed Morrow, Geoff Germane and David Bowen on the Art of Using Trusts to Avoid Utah Income Tax*, LISI Income Tax Planning Newsletter #111 (April 17, 2017). For citations and links to the various trust residency and source income statutes, regulations and other guidance, contact the author for a 50 state plus DC chart compiled for a prior CLE entitled *INGs – Not Just for State Income Tax Avoidance*.

[145] See *The Art of Avoiding Ohio Income Tax Using Trusts*, Ed Morrow, Probate Law Journal of Ohio, May/June 2014, Volume 24, Issue 5, keeping in mind the more recent Ohio Supreme Court case of *T. Ryan Legg Irrevocable Trust v. Testa*, 2016-Ohio-8418 that was decided after that article.

[146] See the companion LISI article for how New York has made multiple changes to its source income rule in recent years. For examples of the quirks, opportunities and differences that may be accorded to sales of LPs/LLPs versus manager-managed and member-managed LLCs, see *Federal and Oregon Income Tax Planning for Trusts,* Oregon State Bar Taxation Section *Vol. 18, #2, Summer 2015* at http://osbartax.com/assets/userfiles/files/Tax_2015Sum.pdf.