*“Permanently high estate tax exemptions, portability and higher trust income tax rates after American Taxpayer Relief Act of 2012 (“ATRA”) force us to fundamentally rethink trust design, especially for couples with under $10.5 million in assets. This commentary proposes various methods to ensure optimal basis increases and better ongoing income tax treatment over traditional AB trust design, including application to existing irrevocable trusts.*

*Three advantages of the Optimal Basis Increase Trust (OBIT) are examined: 1) giving the surviving spouse a limited power to appoint, but enabling both the appointment and the appointive trust to trigger the Delaware Tax Trap over the appointed assets; 2) giving the surviving spouse a general power to appoint appreciated assets up to the surviving spouse’s remaining applicable exclusion amount and 3) ensuring that either method does not cause a "step down" in basis and is applied for the most efficient increase.”*

Now, **Ed Morrow** provides **LISI** members with important commentary on what he refers to as the “Optimal Basis Increase Trust.” As he points out in his commentary, the OBIT should give substantial financial incentives for clients to revisit their estate plan. **Ed Morrow, J.D., LL.M., CFP®**, is an Ohio attorney and national wealth specialist with [**Key Private Bank**](http://www.linkedin.com/pub/edwin-morrow/b/a4a/195)**.** Portions of his commentary were presented to the Purposeful Planning Institute’s CLE and National Business Institute CLE in May 2011.

Here is Ed’s commentary:

**EXECUTIVE SUMMARY:**

Permanently high estate tax exemptions, portability and higher trust income tax rates after American Taxpayer Relief Act of 2012 (“ATRA”) force us to fundamentally rethink trust design, especially for couples with under $10.5 million in assets. This commentary proposes various methods to ensure optimal basis increases and better ongoing income tax treatment over traditional AB trust design, including application to existing irrevocable trusts.

**FACTS:**

“*It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to chan*ge.” – Charles Darwin

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

First, we’ll describe the main *income* tax problems with the current design of most trusts in light of portability and the new tax environment – and problems with more simplified “outright” estate plans. In Part II, we’ll describe potential solutions to the basis issue, including the use of various marital trusts (and the key differences between them), and why these may also be inadequate. In Part III, we’ll explore how general and limited powers of appointment and the Delaware Tax Trap can achieve better tax basis adjustments than either outright bequests or typical marital or bypass trust planning.

I will refer to any trust using these techniques as an Optimal Basis Increase Trust. In Part IV, we will discuss the tremendous value of applying these techniques to pre-existing irrevocable trusts. Lastly, in Part V, we’ll discuss various methods to ensure better *ongoing* income tax treatment of irrevocable trusts – not just neutralizing the negatives of trust income taxation, but exploiting loopholes and efficiencies unavailable to individuals. I will refer to these two groups of techniques taken together as an Optimal Basis Increase and Income Tax Efficiency Trust[[1]](#endnote-1), features of which are summarized in the chart that can be seen in this link: [Chart](http://leimbergservices.com/collection/MorrowChart.pdf)

**Responding to the Portability Threat -- and Opportunity**

The **Tax** Relief, Unemployment Insurance Reauthorization, and Job Creation **Act** of **2010 (“**2010 Tax Act”) introduced a profound change to estate planning that was recently confirmed by the American Taxpayer Relief Act of 2012 (“ATRA”). Section 303 of the 2010 Tax Act, entitled “Applicable Exclusion Amount Increased by Unused Exclusion Amount of Deceased Spouse”, is commonly known as “portability”.[[2]](#endnote-2) ATRA recently made this provision permanent, along with a $5,000,000 exemption for estate, gift and generation skipping transfer tax, adjusted for inflation (even with low inflation, it has already increased to $5,250,000).[[3]](#endnote-3)

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

Portability has been described as both the “death knell” of the AB Trust[[4]](#endnote-4) as well as a “fraud upon the public”.[[5]](#endnote-5) Ubiquitous popular financial press articles now refer to the “dangers” of traditional AB trust planning or the “death of the bypass trust”. While these charges have some surface justification, they all fail to see the tremendous *income* tax opportunities opened up to trusts by the new law – if trusts are properly adapted.

The lure of portability and a large exemption is indeed a siren song for some married taxpayers to avoid trusts. Like Odysseus, we should listen to it despite of our misgivings. The new exemption level, coupled with the advantages of portability, eliminates what was previously the most easily quantifiable reason to do trust planning – saving estate tax - for the vast majority of taxpayers. More than that, however, the new tax environment seemingly deters taxpayers from using trusts through significant *income* tax disparities, despite the many non-tax reasons for using them.

**What’s wrong with the traditional AB trust?**

1) **No Second “Step Up” in Basis for the B Trust for the Next Generation.** Imagine John leaves his wife Jane $3 million in a bypass trust and Jane outlives him 10 years. Over that time the income is spent but the fair market value has doubled to $6 million. Jane has her own $3 million in assets. At Jane’s death, their children inherit assets in the bypass trust with only $3.5 million in basis (assuming net $500,000 realized gains over depreciation or realized losses). Had John left his assets to her outright or to a differently designed trust and Jane elected to use her Deceased Spousal Unused Exclusion Amount (DSUEA), heirs would receive a new step up in basis to $6 million, potentially saving them $750,000 or more![[6]](#endnote-6)

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

3) **Special assets can cause greater tax burden in trust.** Assets such as IRAs, qualified plans, deferred compensation, annuities, principal residences, qualifying small business stock and S corporations are more problematic and may get better income tax treatment left outright to a surviving spouse or to a specially designed trust – retirement plan assets left outright get longer income tax deferral than assets left in a bypass trust.[[7]](#endnote-7) Outright bequests of such assets get around many problematic “see-through trust” rules and the minefield of planning and funding trusts with “IRD” (income in respect of a decedent) assets.[[8]](#endnote-8) Other assets, such as a personal residence, have special capital gains tax exclusions or loss provisions if owned outright or in a grantor trust.[[9]](#endnote-9) Ownership of certain businesses requires special provisions in the trust that are sometimes overlooked in the drafting, post-mortem administration and/or election stages.[[10]](#endnote-10)

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

**Why not just skip the burdens of an ongoing trust?[[11]](#endnote-11) Here’s a quick dozen reasons:**

1. A trust allows the grantor to make certain that the assets are managed and distributed according to his/her wishes, keeping funds **“in the family bloodline”.** Sure, spouses can agree not to disinherit the first decedent’s family, but it happens all the time – people move away, get sick and get remarried – the more time passes, the more the likelihood of a surviving spouse remarrying or changing his or her testamentary disposition.[[12]](#endnote-12)
2. Unlike a trust, assets distributed outright have **no asset protection from outside creditors** (unless, like an IRA or qualified plan, the asset is protected in the hands of the new owner) - whereas a bypass trust is ordinarily well-protected from creditors;
3. Unlike a trust, assets distributed outright have **no asset protection from subsequent spouses when the surviving spouse remarries.** Property might be transmuted or commingled to be marital/community property with new spouse. If it is a 401(k) or other ERISA plan, it might be subject to spousal protections for the new spouse (which cannot be cured via prenup, and become mandatory after a year of marriage).[[13]](#endnote-13) Most states also have spousal support statutes which require a spouse to support the other - and there is no distinction if it is a second, third or later marriage. Also, most states have some form of spousal elective share statutes that could prevent a surviving spouse from leaving assets to children to the complete exclusion of a new spouse;
4. Unlike a trust, assets left outright **save no STATE estate or inheritance tax** unless a state amends its estate tax system to allow similar DSUEA elections (don’t hold your breath – none have yet). This savings would be greater in states with higher exemptions and higher rates of tax, such as Washington State (19% top rate) or Vermont (16% top tax rate), both with $2 million exemptions. Assuming growth from $2 million to $3 million and a 16% state estate tax rate, that savings would be nearly $500,000!
5. Unlike a bypass trust, income from assets left outright **cannot be “sprayed”** to beneficiaries in **lower tax brackets**, which gets around gift tax but more importantly for most families can lower overall family income tax – remember, the 0% tax rate on qualified dividends and long-term capital gains is still around for lower income taxpayers!
6. The Deceased Spousal Unused Exclusion Amount (DSUEA), once set, is **not indexed for inflation**, whereas the Basic Exclusion Amount (the $5 million) is so adjusted after 2011 ($5.25 million in 2013). The growth in a bypass trust remains outside the surviving spouse's estate. This difference can matter tremendously where the combined assets approximate $10.5 million and the surviving spouse outlives the decedent by many years, especially if inflation increases or the portfolio achieves good investment returns;
7. The **DSUEA from the first deceased spouse is lost** **if the surviving spouse remarries** **and survives his/her next spouse’s death** (even if last deceased spouse’s estate had **no** unused amount and/or made no election). This result, conceivably costing heirs $2.1 million or more in tax, restrains remarriage and there is no practical way to use a prenuptial (or postnuptial) agreement to get around it;
8. **There is** **no DSUEA or “portability” of the GST exemption**. A couple using a bypass trust can exempt $10.5 million or more from estate/GST forever, a couple relying on portability alone can only exploit the surviving spouse’s $5.25 million GST exclusion. This is more important when there are fewer children, and especially when these fewer children are successful (or marry successfully) in their own right. For example, a couple has a $10.5 million estate and leaves everything outright to each other (using DSUEA), then to a trust for an only child. Half will go to a GST non-exempt trust (usually with a general power of appointment), which can lead to an additional $5.25 million added to that child’s estate – perhaps needlessly incurring more than $2 million in additional estate tax.
9. Unlike a bypass trust, **portability requires the executor to timely and properly file an estate tax return** to exploit the exclusion. This is easy for non-professional executor/trustees to overlook and lose. Unlike some areas of tax law, the IRS is **not** authorized here to grant exceptions or extensions for reasonable cause;
10. Unlike a bypass trust, outright bequests cannot be structured to better accommodate **incapacity or government benefits (e.g. Medicaid) eligibility planning**;[[14]](#endnote-14)
11. A **bypass trust can exploit the serial marriage loophole**. Example: John Doe dies leaving his wife Jane $5.25 million in a bypass trust. She remarries and with gift-splitting can now gift $10.5 million tax-free. If husband #2 dies using no exclusion – Jane can make the DSUEA election and have up to $10.5 million Applicable Exclusion Amount (AEA), even with the $5.25 million in the bypass trust John left her, **sheltering over $15.75 million** (three exclusion amounts, not adjusting for inflation increases) for their children without any complex planning, not even counting growth/inflation. Had John and Jane relied on outright or marital trust, even w/DSUEA, their combined AEA would be capped at two exclusion amounts ($10.5 million, not adjusting for inflation increases) – a potential loss of over $2 million in estate tax.
12. Portability only helps when there is a *surviving* spouse. It may not work in a **simultaneous death** situation, whereas a bypass trust with proper funding or a simultaneous death clause imputing John as the first to die and Jane as survivor **would**.[[15]](#endnote-15)

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

**Thinking Outside the “Outright Bequest v. Bypass Trust” Box**

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

Attorneys may wish to consider a savings clause/funding variant similar to the Clayton QTIP[[16]](#endnote-16) to save the use of the exclusion via bypass trust even if the Form 706 filing to claim portability is botched.[[17]](#endnote-17) The Clayton QTIP/bypass trust combination may also save additional basis if the surviving spouse dies within 15 months.

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

Extreme, but not uncommon, scenarios such as this could save hundreds of thousands of dollars in basis by building flexibility into the plan. Even a heavy bond portfolio (approximately 10 yr duration) could easily decrease in value 25% if interest rates went up a couple percentage points.[[18]](#endnote-18) Practitioners may want to file for a six month extension on Form 706 even if no estate tax would be due to buy additional time, unless one of the preferred Optimal Basis Increase Trust design options, discussed in Part III, is utilized.

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

We should consider at least two well known alternatives that get us closer to preserving the best basis increase for the family. First, let’s consider the use of marital deduction trusts. This may strike some people as a very odd concept – why would someone use a marital deduction trust if there is no need for the federal marital deduction? Two reasons – the first is to exploit *state* estate tax savings, especially since most of these states allow a different state QTIP election.

Secondly, these are simple vehicles that get a second step up in basis without sacrificing the asset protection and control of a trust. Succeeding trusts/beneficiaries generally receive a new basis when assets are in the decedent beneficiary’s estate in a general power of appointment (GPOA) marital trust or a qualified terminal interest property (QTIP) marital trust.[[19]](#endnote-19)

The QTIP marital trust can be more restrictive at second death than a GPOA marital trust, by restricting or even eliminating the surviving spouse’s power to appoint.[[20]](#endnote-20) However, especially in smaller estates of couples with children of the same marriage, and states with no state estate tax or a high exemption, ***the GPOA marital trust should see a rise in popularity*** because of the absence of any need to file a Form 706 to get the second step up in basis, the better compatibility with disclaimer planning and the reduced risk of valuation discounts hampering basis increase.

Example: John and Jane, married, in their mid 70s, have less than $1 million each. They wish to leave assets in trust to each other for all the various non-tax reasons herein, but want to preserve the second step up in basis at the second death. Using a QTIP design requires the first decedent’s executor to file a costly Form 706 with the appropriate QTIP election - otherwise, it’s no different than a bypass trust, and won’t get a step up in basis at the second spouse’s death. However, using a GPOA marital trust does not require such a filing. Even if *no* Form 706 is filed at the first death, assets in the GPOA marital get a new adjusted basis at the second death.[[21]](#endnote-21) Furthermore, their attorney knows that John and Jane probably won’t completely fund their trust and may need to disclaim some assets to fund the trust. A QTIP trust with a standard limited power of appointment (“LPOA”) requires disclaiming the LPOA as well, whereas a testamentary GPOA can be retained by a spouse without tainting a qualified disclaimer.[[22]](#endnote-22) Using various techniques discussed further below, John and Jane also curtail the threat of the GPOA potentially altering their estate plans, so the GPOA marital will probably be the better design for their trust.

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

Example: John and Jane, in the example above, plan to fund their trust with their 50% interest in a home valued at $600,000 and 50% of rental property LLC, underlying asset value $500,000. If a QTIP is used, the surviving spouse’s estate must value the ½ in QTIP and the ½ in the surviving spouse’s estate separately, generating a fractional interest, and/or marketability, non-controlling interest “discount”.[[23]](#endnote-23) At second death, these values might total $500,000 and $300,000 respectively rather than $600,000 and $500,000. This reduction in valuation would be optimal planning *if* Jane had a taxable estate, but for most people, *“discounting” will save no estate tax and cost the heirs significant basis increase* – for Jane and John’s family, $300,000. Had the 50% interest in the home and 50% LLC interest gone to a GPOA marital trust for the survivor, the two halves would be valued together for estate tax at the second death, and therefore retain full FMV of basis.[[24]](#endnote-24)

GPOA trusts may also be preferred for taxpayers in states such as New York and New Jersey that do not permit a separate state QTIP election.[[25]](#endnote-25) Another reason marital GPOA trusts might be preferred for taxpayers with estates under the applicable exclusion amount is potential threat posed by IRS Rev. Proc. 2001-38. Rev. Proc. 2001-38 outlines a procedure to permit taxpayers and the IRS to disregard a QTIP election, even though the election is irrevocable, under certain circumstances. It was clearly designed to help taxpayers who unnecessarily over-qtipped what should have remained a bypass trust. There is no indication that the IRS will use it as a weapon of attack, against a taxpayer’s interests, yet it does purportedly allow them to “disregard the [QTIP] election and treat it as null and void for purposes of sections 2044(a), 2056(b)(7), 2519(a) and 2652.”[[26]](#endnote-26)

Since the basis rules under IRC §1014(b)(10) reference inclusion via IRC §2044, this would be a problem in preserving a second basis increase, because denying the QTIP election would deny inclusion under IRC §2044, and hence deny the new basis. There are persuasive arguments that this Rev. Proc. should not entitle the IRS to retroactively disregard a validly made QTIP election on their own accord. However, until the IRS issues further guidance some practitioners may prefer to avoid the issue altogether and use a GPOA for their marital trust (or use intervivos QTIPs, to which the Rev. Proc. does not apply, if your state has fixed other intervivos QTIP problems).[[27]](#endnote-27) This will depend on whether a GST/reverse QTIP election would be used, the compatibility of the estate plan with powers of appointment and other factors. QTIPs will probably remain the preferred vehicle for potentially estate taxable estates.

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

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

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

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

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

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

3) giving another party or parties (typically a child, but it could be a friend of spouse or non-beneficiary)[[28]](#endnote-28), a non-fiduciary limited lifetime power to appoint to the surviving spouse;

4) giving the surviving spouse a limited power to appoint, but enabling both the appointment and the appointive trust to trigger the Delaware Tax Trap over the appointed assets;[[29]](#endnote-29)

5) giving the surviving spouse a limited power to appoint that alternatively cascades to a general power to the extent not exercised.[[30]](#endnote-30)

6) giving the surviving spouse a general power to appoint appreciated assets up to the surviving spouse’s remaining applicable exclusion amount.

This commentary will focus on the advantages of the last three of these, referred to as an Optimal Basis Increase Trust. The problem with the first two above techniques, which involve placing the burden on the trustee or trust protector, is that they are often impractical and *require an extraordinary amount of proactivity and omniscience, not to mention potential liability (for actions and inactions) for the trustee or trust protector*.

Gallingly, clients don’t tell us when they are going to die, hand us accurate cost basis and valuation statements, marshal beneficiary agreement and give us enough time to amend, decant or go to court to change the estate plan to maximize tax savings. Furthermore, fiduciaries taking such drastic steps are likely to wish to hire counsel, get signed waivers, or consult a distribution committee – time for which may be scarce in a situation where the surviving spouse is hospitalized or terminally ill.

Distributing assets outright to the surviving spouse, even if clearly under the authority of the trustee, protector or donee of a power of appointment, risks losing the asset protection for the family and risks a disinheritance or removal outside in the family bloodline. Plus, we’ve all heard cases of someone on death’s door that miraculously makes a full recovery and lives another decade or more. Once the assets are out of trust, you can’t simply put them back in and have the same tax results.

Adding a general testamentary power of appointment does not have quite the same level of risk, nor the same destruction of asset protection from outside creditors, as an outright distribution.[[31]](#endnote-31) However, even if permitted by the document, by decanting statute and/or approved by a court, such a technique risks retroactively disqualifying an earlier-made qualified disclaimer as well as disqualifying a “see-through” trust if IRA or other retirement benefits are (or were?) payable to the trust. This may be true even if the trust qualified at the time, and even if the power remains unused.[[32]](#endnote-32)

The third technique, using a limited lifetime power of appointment, avoids some of these drawbacks, but breeds others. We have all seen cases where a spouse remarries, and perhaps one child would happily distribute 100% to mom or dad whenever they asked, but the other children would be livid (and potentially disinherited indirectly by their sibling). There is no reason that such a lifetime limited power to appoint could not be made conditional upon unanimous consent of the children, but this of course brings up the possibility of one child’s obstinance holding back the family’s tax planning.

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

We’ll now turn to the 4th, 5th and 6th methods above, which use formula powers of appointment to allow for firmer and more precise tax planning. I will refer to all of these variants together as an Optimal Basis Increase Trust (OBIT).

***Part III - The Optimal Basis Increase Trust (OBIT)***

Using testamentary general and limited powers of appointment (“GPOAs” and “LPOAs”) more creatively can assure that assets in the trust receive a step up in basis, but not a step DOWN in basis, and these can be dynamically defined or invoked so as to not cause additional state estate tax.

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

Traditional deductible IRA[[33]](#endnote-33) basis $0, FMV $700,000

Total “IRD” Property basis $0 FMV $700,000

Apple Stock (the iPhone 10 flopped), basis $500,000, FMV $200,000

Condo in Florida (hurricane depresses value), basis $1,000,000, FMV $600,000

LT Bond portfolio (inflation depressed value) basis $400,000 FMV $300,000

Various stocks that have decreased in value basis $150,000, FMV $100,000

Total “loss” property basis $2,050,000,FMV $1,200,000

Rental Real Estate[[34]](#endnote-34) basis $200,000, FMV $600,000

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

ST Bond Portfolio, Money market basis $400,000, FMV $400,000

Gold basis $100,000 FMV $200,000

Total “gain” property basis $1,100,000,FMV $2,100,000

Total at Jane’s death basis $3,150,000 FMV $4,000,000

Had John used an outright bequest, or a marital trust, all of the assets above (except the IRA) would get a new cost basis – including the loss properties.[[35]](#endnote-35) Had John used an ordinary bypass trust, none of the assets above would get a new cost basis, including $1 million of unrealized gains (see chart below)!

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

**New Basis at Surviving Spouse’s Death if using: Ordinary Bypass QTIP/outright OBIT**

Traditional deductible IRA $0 $0 $0

Apple Stock (the iPhone 9 flopped), $500,000 $200,000 $500,000

Condo in Florida (hurricane depresses value) $1,000,000 $600,000 $1,000,000

LT Bond portfolio (inflation depressed value) $400,000 $300,000 $400,000

Various stocks that have decreased in value $150,000 $100,000 $150,000

Rental Real Estate $200,000 $600,000 $600,000

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

ST Bond Portfolio, Money market $400,000 $400,000 $400,000

Gold $100,000 $200,000 $200,000

**Total Basis for Beneficiaries at Jane’s death $3,150,000 $3,300,000 $4,150,000**

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

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

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

Let’s revisit our example above. Let’s say Jane has $3 million of her own assets. Her DSUE from her late husband John was $3.25 million (frozen, not adjusted for inflation), and her own basic exclusion amount is $6.25 million ($5.25 million plus 8 years of estimated inflation adjustments adding $1 million more). Even if she had missed the Form 706/portability filing, adding $2.1 million to her estate doesn’t even come close to her $9.5 million applicable exclusion amount. But what if Jane wins the lottery and has $9 million in her estate without John’s trust? Could this type of trust provision cause $640,000 of additional estate tax ($9 million plus $2.1 million, minus $9.5 million AEA, times 40% rate)?

Fortunately, John’s Optimal Basis Increase Trust includes a formula. The GPOA is only applicable to those assets to the extent it does not cause increased federal estate tax (and takes into account state estate tax, discussed further below). Powers of appointment can be limited in scope as to either appointees or assets. Many existing trusts already have GPOAs over only a portion of the trust (typically, the GST non-exempt share). There is no reason one cannot grant a general power of appointment over less than 100% of trust assets, or by formula.[[36]](#endnote-36) All of our traditional planning has A/B/C, GST formulas that the IRS has blessed and this is no different.

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

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

Assets that may incur higher tax rates, such as collectibles (artwork, antiques, or gold, in the example above) would be natural candidates for preference. On the opposite end of the spectrum, other assets might have lower tax rates or exclusions, such as qualifying small business stock or a residence that a beneficiary might move into, but those would be relatively rare situations. Most families would prefer the basis go to depreciable property, which can offset current income, before allocating to stocks, bonds, raw land, family vacation home, etc. Therefore, ultimately a weighting may be optimal, but at the most basic level practitioners would want the GPOA to apply to the most appreciated assets first.

Some of this analysis will sound similar to those who handled estates of those who died in 2010 when the price to pay for no estate tax was a limited step up in basis. While the concept sounds similar, in practice, it is quite different. In 2010 the executor could choose assets to apply a set quantity of basis to, pursuant to specific statute.[[37]](#endnote-37) Ideally, we would like to give Jane’s executor or the trustee the power to choose the assets to comprise the $500,000 of appointed assets – in both drafting and in practice that is deceptively simple. However, this is quite different from 2010 carry over/step up law, and different from “pick and choose” formula funding.

If the power of appointment is deemed to apply to a pecuniary amount (here, $500,000), rather than a fractional formula (500,000/2,100,000), it may have undesired income tax consequences.[[38]](#endnote-38) Thus, we should avoid simple powers of appointment over, for example, “an amount of assets equal to my spouse’s remaining applicable exclusion amount”.

If Jane’s testamentary power potentially extends to all of the applicable property equally ($2.1 million), only limited to $500,000, all property subject to that provision should get a fractional adjustment to basis accordingly – no different than if a child dies at age 36 and had a power to withdraw 1/3 of corpus at age 35 and did not take it – all assets would get a 1/3 basis adjustment.[[39]](#endnote-39) A pro rata adjustment would lead to wasted basis, since a $1,000,000 asset with $1 gain would soak up the same applicable exclusion amount as a $1,000,000 asset with $900,000 gain. This would be better than no extra basis at all, but not as optimal as the trustee limiting the powerholder’s general power, or, more conservatively, establishing an ordering rule.

The trustee might be given a fiduciary limited power of appointment to choose the appointive assets subject to the beneficiary’s general power of appointment. Black letter law defines a power of appointment as “a power that enables the donee of the power to designate recipients of beneficial ownership interests in *or powers of appointment over* the appointive *property*.”[[40]](#endnote-40)

Arguably, a trustee with such a power would be the donee of a fiduciary limited power of appointment to designate recipients of powers of appointment over the appointive property.[[41]](#endnote-41) Assuming the trustee is independent, this could arguably limit the spouse/donee’s GPOA over only specific assets chosen by the trustee.

However, it is probably more conservative and simpler in concept to simply make clear the GPOA never applies to the less appreciated assets, and is never subject to any powerholder’s discretionary choice.

So, in our example, the trust provides that GPOA applies to the most appreciated asset first, cascading to each next individual asset until $500,000 in total property is reached. In our case, the real estate has the greatest appreciation (assuming there is not a more appreciated stock in “various stocks” category), thus the GPOA would apply to 5/6 interest (be it % as tenant in common, or more likely, % LLC membership interest). Thus, the basis would be increased to FMV on the date of Jane’s death as to 5/6 of the property (5/6 times $600,000, or $500,000) and the remaining 1/6 would retain its carry over basis (1/6 of $200,000, or $33,333).[[42]](#endnote-42) This means a basis increase from $200,000 to $533,333. This method could easily make for a rather extensive spreadsheet when dealing with many dozens of individual stock positions. But, this is no different from what executors and their accountants had to build in 2010.

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

If the spouse is the sole trustee or sole investment advisor under direction or delegation, could his or her indirect power to affect gains and losses on investments, and therefore basis, somehow deem such powers to be general over all the assets up to the remaining applicable exclusion amount? This would be quite a stretch, since the Uniform Prudent Investor Act and other fiduciary duties preclude any self-dealing or avoidance of diversification unless the document waives those duties. Still, this may simply be one more reason for a conservative practitioner to use an independent trustee, co-trustee and/or investment trustee.[[43]](#endnote-43)

If such a design is undesirable, it may be good reason to rely instead on granting the spouse a limited testamentary power of appointment eligible to trigger the DTT, which could be over all assets equally. Any structuring to exploit a step up or avoid a step down would be done through the spouse’s own Will or Trust exercising the non-fiduciary LPOA, rather than through the trust document or vagaries of investment return, and therefore immune to any such argument.

**Variations to Accommodate Separate *State* Estate and Inheritance Taxes**

We do not want inclusion in the federal estate, even if it causes no estate tax, to also inadvertently increase *state* estate tax, unless there is a greater overall income tax benefit.[[44]](#endnote-44) Consider the extremes: we may not want to grant a GPOA over stock bought at $95 rising to $100 at date of powerholder’s death, because the $1 or so in potential capital gains tax savings does not justify inclusion if the state estate tax incurred is $12-16! Clients in those states may have a $1 of $2 million state estate tax exempt trust and up to $3.25 or $4.25 million state-QTIPed trust. Obviously the latter is first choice to cull any basis from by inclusion in the beneficiary’s estate.

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

Practitioners in states with a $1 million estate tax exemption may opt for simplicity of drafting/administration and simply forego the GPOA over any state-estate tax exempt trust property, since the savings would not be as great. However, surviving spouses may change residence or the state tax regime may change (as it has recently in Ohio, Indiana and other states). Some states have larger exemptions of $2 million, $3.5 million or more that make it more compelling. Practitioners may want to modify their formula with something similar to soak up available state estate tax exclusion, and then limit appointive assets above the amount of available state estate tax exclusion.

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

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

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

If the GPOA marital deduction is claimed, any GPOA must include the spouse or spouse’s estate, not just creditors, and must be “exercisable by such spouse alone and in all events”.[[45]](#endnote-45) However, if no marital deduction was claimed, as we aim to do in an Optimal Basis Increase Trust, the following limitations may be included:

A GPOA may limit the scope of eligible beneficiaries so long as creditors of the powerholder are included. For example: “I grant my beneficiary the testamentary power to appoint to any of my descendants [or to any trust primarily therefore, which is usually an option for trusts not designed to qualify as a “see through accumulation trust” for retirement benefits]. My beneficiary also may appoint to creditors of his or her estate.”[[46]](#endnote-46)

Furthermore, a power is still a GPOA if it may only be exercised with the consent of a non-adverse party.[[47]](#endnote-47) Surprisingly, even a trustee with fiduciary duties to other beneficiaries is not considered adverse.[[48]](#endnote-48) For example, one might add to the above: “However, my beneficiary may only exercise said appointment with the consent of [name of non-adverse party, or] my trustee, who must be a non-adverse party.” If you name a trustee, then you would then want provisions to enable appointment of a non-adverse party as trustee if, for instance, a beneficiary were the successor trustee (and adverse) and the beneficiary actually attempted to appoint to their creditors. If you name a non-adverse party, make sure to name alternates in the event the first is deceased or incapacitated. In theory, one could name multiple non-adverse parties necessary for unanimous consent, but that pushing the envelope is hardly necessary.

Furthermore, a GPOA is “considered to exist on the date of a decedent's death even though the exercise of the power is subject to the precedent giving of notice, or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the decedent's death notice has been given or the power has been exercised.”[[49]](#endnote-49) This offers even more opportunity to make GPOAs more difficult to actually exercise, yet still come within the safe harbor of a treasury regulation.

If there is a qualified plan or IRA payable to the trust designed to be a see through trust (specifically, an “accumulation” trust, it would not be necessary for a “conduit” trust), one might consider a further restriction to prevent disqualification – “to creditors *who are individual persons younger than [intended designated beneficiary*]”. This is a technique seemingly blessed by a recent PLR that permitted such a circumscribed GPOA to retain see through trust status.[[50]](#endnote-50) Although the OBIT techniques herein to increase basis would not apply to IRAs or qualified plans,[[51]](#endnote-51) you may yet have a GST non-exempt share over which a GPOA is desired. It would probably be preferred to use a conduit trust or trusteed IRA instead, but if for some reason that is undesirable, there may not be a lot to lose in circumscribing the GPOA in this manner as applied to such a trust.

Generally, I would not attempt to limit a GPOA in this manner for any non-standalone IRA accumulation trust – requiring appropriate non-adverse parties’ consent should be more than adequate to prevent unwanted exercise. That said, it may still be prudent to limit the power to appoint to creditors to the amount of the debt owed and to reasonably equivalent value for contractual debt.[[52]](#endnote-52)

While a handful of states have creditor-friendly state law impacting testamentary GPOAs, the law is generally favorable as to whether and when a testamentary general power of appointment subjects the appointive assets to the donee powerholder’s creditors, although in bankruptcy the assets are not subject to creditors.[[53]](#endnote-53) It may depend on whether the power is exercised or whether it is merely allowed to lapse. Creditor access should be less likely if there are additional consent and notice requirements as discussed above, but again this depends on state law and there are apparently no cases discussing asset protection differences of GPOAs with the various proscriptions described above. This is in stark contrast to the exposure of a *presently* *exercisable* general power, which will be discussed further below.

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

In our examples of John and Jane Doe above, we presumed that the Optimal Basis Increase Trust used a formula GPOA to cause estate inclusion and increased basis. However, there is also a technique to accomplish the same result with a *limited* power of appointment. This involves IRC §2041(a)(3), colloquially known as the Delaware Tax Trap (“DTT”).[[54]](#endnote-54) The application of this rule, in conjunction with the rule against perpetuities, is complex. I will refer the reader to more learned articles on the subject, but will only hit the highlights of the practical import of this for purposes of this article.[[55]](#endnote-55)

Generally, if Jane in our example had a limited power of appointment which permitted appointment in further trust, and Jane appointed those assets to a separate trust which gives a beneficiary a *presently exercisable* general power of appointment, this would trigger §2041(a)(3), cause estate inclusion, and therefore an increased basis under IRC §1014, just as a standard GPOA would.[[56]](#endnote-56)

Thus, Jane’s Will (or trust or other document, if permitted by John’s trust) would appoint any appreciated assets to such a “Delaware Tax Trapping” trust as discussed above. In drafting mode, this is probably not an optimal strategy to employ for John’s trust, because it will necessarily require Jane to draft a new Will invoking the LPOA and a new appointive trust with terms that one would ordinarily avoid. Giving a beneficiary a presently exercisable GPOA impairs asset protection much more than a testamentary power, and destroys any chance of spraying income or making tax-free gifts, nor does it allow avoidance of state or federal estate taxation or avoidance of a step down in basis at the child’s death.[[57]](#endnote-57)

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

Practitioners could even craft a “Crummey” like provision into the appointive trust so that the presently exercisable GPOA lapses into a self-settled, incomplete gift domestic asset protection trust with situs in Ohio, Delaware, Alaska or other permitted state after 30 days.

**Optimizing Basis Increase at *First* Death**

Married couples living in community property states automatically receive a new date of death basis for community property (which can, of course, mean a step down in basis for property as well).[[58]](#endnote-58) This might exclude significant property that might be separate – such as assets gifted or inherited property or assets earned prior to marriage. Increasing step up in basis at first death for such separate property (and avoiding double step downs for community property that has tanked in value) may be accomplished through postnuptial transmutation agreements.

Those living in separate property states may be able to accomplish the same result through the use of an Alaska Community Property Trust, keeping “loss” or qualified plan property out of the trust and transferring gain property to the trust to count as community property.[[59]](#endnote-59) While there is a compelling argument that those should work equally well, to date this technique has not been tested in the courts or subject to any IRS ruling.

Example: John and Jane are on their second marriage and therefore have significant separate property. In a community property state, John and Jane might each agree that $1 million of their low basis property is community property. In a non-community property state, they might put those assets into an Alaska Community Property Trust. Of course, if John’s former separate property value skyrockets to $2 million, and Jane’s stays the same at $1 million, and they are later divorced, this $3 million is 50/50 for divorce purposes. But many clients could live with this, when considering that if one dies, all $3 million gets a new adjusted basis – a substantial windfall for the widow/widower and potentially others.

The so-called “joint GPOA” (aka poorer spouse funding technique) trust proposed by some to use in separate property states could be a disaster, because IRC §1014(e) would probably require a step down, but deny a step up.[[60]](#endnote-60) The IRS would consider this property transferred by gift and returned to the donor (or trust therefore) within one year. There may be colorable arguments that it should still be eligible for a basis increase, but you have at least four PLRs to the contrary and an uphill battle to argue for it.

**Increased Asset Protection Opportunities and Basis Plays Due to the Larger Exclusion Using Lifetime Trusts *(the “poor man’s DAPT”?)***

The increased exclusion also offers up greater asset protection planning opportunities. Consider this variant for smaller estates: Husband sets up an irrevocable trust (aka SLAT) for Wife (defined as whomever he is married to at the time, since we do not need to qualify for the marital deduction as an intervivos QTIP or GPOA). Wife has a testamentary GPOA, circumscribed as discussed above. Wife and/or children have a *lifetime* limited power of appointment to appoint to Husband/Father. Merely being a permissive appointee of a limited power of appointment should not threaten asset protection, even if the donor of the power is a permissive appointee. If wife dies first, and the GPOA is not exercised, or if it is exercised successfully in favor of the husband, husband becomes beneficiary of the trust. Unlike intervivos QTIPs or LPOA exercises that “relate back” (thus making it self-settled as to Husband), the settlor changes at Wife’s death pursuant to a GPOA (though with a lapse of the GPOA, it may only change as to 95%).[[61]](#endnote-61) This means that the trust is not self-settled if Husband later becomes beneficiary. OBIT techniques can be used here as well to avoid any step downs in basis at wife’s death, or limit inclusion should she have a taxable estate.

In some states, you can achieve very close to DAPT protection with an intervivos QTIP as well, so that less gift/estate tax exclusion is used for clients of larger estates.[[62]](#endnote-62) In other states, an intervivos GPOA marital may be preferred to achieve the same tax and asset protection result.

Furthermore, you have flexibility regarding grantor trust status for income tax purposes after W’s death. If W exercises her testamentary general power of appointment, she would be considered the grantor after her death. However, if she merely lets her GPOA lapse, she would not be- a result that the family may prefer.[[63]](#endnote-63) This is yet another area where state law, estate tax and income tax law do not necessarily stride in lock step.

Unlike DAPTs, which have to be done in certain states, use certain trustees, and have various uncertainties, requirements and drawbacks, such trusts can be done in any state. However, some states may wish to reinforce the common law, as Ohio has recently done, that merely being a permissive appointee under a lifetime power of appointment does not make a trust “self-settled”.[[64]](#endnote-64)

**Part IV - Use of Optimal Basis Increase Techniques by Pre-Existing Irrevocable Trusts**

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

Most importantly, practitioners should not overlook the significant value in adapting many pre-existing irrevocable bypass trusts (including intervivos SLATs) to fully use this $5.25 million (and increasing) basis increasing “coupon”. This may be done by various ways – triggering the Delaware Tax Trap using an existing limited power of appointment that permits appointment to trusts, or changing the trust via decanting, private settlement agreement or court reformation to add a limited or general power of appointment. Choice of these options will be somewhat state law dependent.

The advantages may be significant. Imagine how many current irrevocable bypass trust surviving spouse beneficiaries have well under $5.25 million in their personal estate? (or more, if their spouse died after 2010 and they elected DSUEA).

Example: John died in 2008, leaving his wife Jane $2 million in non-IRA assets in a typical bypass trust, which has now grown to $3.5 million. Although some of the assets have been sold, rebalanced, the trust assets now have a basis of $2.5 million. Jane’s assets are $2.5 million. Why waste $2.75 million of her $5.25 million “coupon” she is permitted to use to increase basis step up for her family? Jane therefore amends her will/trust to exercise her limited power of appointment granted in John’s trust, mirroring language discussed above: assets with basis greater than FMV or IRD go to a trust for her children (or simply continue in trust under the residuary), and assets with basis under FMV (for which Jane and her family desire the step up) simply go to a similar trust for her children that contains a presently exercisable general power of appointment, triggering IRC §2041(a)(3) and getting the family up to an additional $1 million of basis free of charge. And, of course, this exercise can be limited to her available Applicable Exclusion Amount and applied first to the most appreciated assets first, capped to prevent any estate tax and/or account for any state estate tax as discussed above.

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

But let’s say Jane did not have a limited power of appointment, or doesn’t like the drawbacks of granting the beneficiaries a presently exercisable general power of appointment. Aren’t we taught after *Bosch* and similar cases and PLRs that trying to reform a trust for the marital or charitable deduction post-mortem (or post gift) should not be recognized?[[65]](#endnote-65) Isn’t this a similar trend for see through trust rulings?[[66]](#endnote-66)

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

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

In Rev. Rul. 73-142, a grantor/decedent established a trust for his wife and children, not subject to ascertainable standards, and mistakenly retained the power to remove and become the trustee.[[67]](#endnote-67) Years prior to his death, he went to court to successfully construe the trust to mean that he could not be appointed trustee (nowadays, we would also preclude removal and replacement with any related/subordinate party).[[68]](#endnote-68) The IRS ruled that this court order had tax effect to negate the IRC §2036/2038 issue *despite the state court decree being contrary to the decisions in the state’s highest court*. While this is not an IRC §2041 case, this Rev. Rul. bodes well for such proactive planning to add a limited GPOA for better tax results.

One PLR following Rev. Rul. 73-142 noted a key difference with *Bosch*: “Unlike the situation in *Bosch*, the decree in the ruling [73-142] was handed down before the time of event giving rise to the tax (that is, the date of the grantor's death).”[[69]](#endnote-69) In that PLR, a state court order construing a tax apportionment clause to apply to the GST non-exempt marital share rather than equitably to both GST exempt and GST non-exempt shares was given effect. This was good proactive planning by counsel prior to the taxing event to keep more funds in a GST sheltered trust.

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

The reverse, removing a GPOA, is a more difficult issue, so any reformation should strongly consider the irrevocable nature of it. Generally, releasing a general power of appointment would trigger gift tax, and could trigger taxation of any IRD.[[70]](#endnote-70) However, in one recent PLR, the IRS allowed a post-mortem court reformation to essentially remove a GPOA without adverse tax effect.[[71]](#endnote-71) I would not count on this result for every post-mortem reformation removing a GPOA, but the PLR is instructive as to how the IRS applies the Supreme Court’s holding in *Bosch*.

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

**Part V - The Income Tax Efficiency Trust – Exploiting Ongoing Trust Tax Techniques**

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

Creative use of IRC §663 and/or IRC §678a loopholes can ensure that capital gains are not trapped in trust at the highest rates, may get better tax treatment for special assets, and may even be sprayed to beneficiaries or charities in much lower (or even 0%) brackets. Non-grantor trusts may have an additional advantage in some states in their ability to shelter from state income taxation.

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

The $75,000 principal distribution is not ordinarily included as part of what is called the “DNI deduction”.[[72]](#endnote-72) It is this latter aspect of trust income taxation that is often overlooked and misunderstood by practitioners, and is potentially the source and trap for higher tax. Once the trust is over $11,950 of taxable income (roughly $88,000 in this case), it is taxed at 39.6% (20% if LTCG/dividends), plus, unless it meets an exception such as IRA/QP distributions, it is also subject to the 3.8% surtax. See the December 2012 issue of Trusts and Estates, *Avoiding the Medicare Surtax on Trusts*, for a more extensive article on these points.

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

There are two main methods – 1) using IRC § 678(a) to allow the spouse to withdraw all net taxable income, perhaps specifically including all net capital gains (although “all net income” is common language in trusts, by default this refers to net accounting income, which typically excludes capital gains and losses) or, better, 2) coming within one of the exceptions in Treas. Reg. §1.643(a)-3(b) which allow discretionary distributions to carry out net capital gains.

If capital gains are considered part of her distribution and ordinary non-grantor trust rules are applied, the $40,000 of accounting income and the $75,000 of principal distribution is also taxed to her and only $25,000 is left trapped in trust. However, because of her extra tax burden, she may ask for more distributions to compensate, which would probably lower the income trapped in the trust to well under $11,950. Thus, the 43.4%/23.8% highest marginal trust tax rate is avoided and her personal rates of 28%/15% would be applicable. This can lead to tremendous ongoing tax savings.

Furthermore, the settlor may give additional spray powers to the trustee, to spray income to other beneficiaries, including the family’s favorite charity, donor advised fund or foundation. As an additional backstop for flexibility, the settlor may give the surviving spouse a limited lifetime power of appointment.[[73]](#endnote-73)

For instance, let’s say Barbara receives more income outside the trust, putting her in a higher bracket, and decides that she only needs $30,000 from the trust, but her children could use funds to pay for grandchildren in college. She asks the trustee to consider, and the trustee complies (having instructions to consider secondary beneficiaries if income is sufficient for the primary), spraying $80,000 to her children (or grandchildren) and $20,000 to the family’s donor advised fund at the local community foundation that John had also named in the trust as a permissible beneficiary.[[74]](#endnote-74)

Whether this makes sense depends on the family situation, trust and brackets of the parties involved (and potentially the assets, such as whether an S Corp or IRA is involved, which might suggest separate trusts). There are many scenarios where the family would be far better off with this spray capability, potentially lowering tax rates by 20% or more. Remember, the 0% rate for taxpayers in the bottom two tax brackets for LTCG/qualified dividends was permanently extended with ATRA as well.

Notably, not only would IRC §642(c) offer “above the line” charitable deductions for the family, but it offers a better deal for internationally minded clients with ties/interests in foreign countries – unlike IRC §170 for individuals, the trust income tax charitable deduction is expressly *not* limited to charities organized in the United States.[[75]](#endnote-75)

Furthermore, regulations specifically permit that the governing instrument can provide an ordering rule and control the character of the income distributed via 642(c) provided it “has economic effect independent of income tax consequences.” For instance, if the trust limits the charities’ potential distribution to gross income from net short-term capital gains, taxable interest and rents, it has the economic effect apart from income tax consequences because the amount that could be paid to the charity each year is dependent upon the amount of short term capital gains, taxable interest and rents the trust earns within that taxable year.[[76]](#endnote-76) Therefore, in our example, Barbara’s donor advised fund would not receive any long-term capital gains or qualified dividend or tax exempt income – the $20,000 would be limited to coming from the interest and short term capital gains.

This article will not revisit the various pros and cons of the methods enabling net capital gains to pass out with any distributions to the beneficiary(ies), since it was covered in last December’s article. Practitioners should familiarize themselves with Treas. Reg. 1.643(a)-3(b) due to its increased importance under ATRA.

**Pros and Cons of the Optimal Basis Increase and Tax Efficiency Trust**

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

The ongoing trust income tax techniques discussed herein apply to nearly all estate levels – perhaps even more so to wealthier families. After all, how many trust beneficiaries, even of wealthy families, will always make over $400,000 or $450,000 in taxable income and therefore be subject to the same tax rates as a non-grantor trust?[[77]](#endnote-77) Won’t these families typically get the most from charitable tax deductions in trusts?

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

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

The Optimal Basis and Income Tax Efficiency Trust offers the following advantages over a traditional QTIP: better asset protection during the surviving spouse’s life (for accounting income), no chance of losing DSEU due to remarriage, better ongoing income tax treatment for the primary beneficiary, ability to spray income or capital gains to lower (or 0%) tax bracket beneficiaries, ability to shelter from state estate/inheritance tax, no requirement to file Form 706 to make appropriate QTIP election, no prospect of the IRS using a Rev Proc 2001-38 argument to deny the effect of the election, and the prevention of a second step down in basis.

Just as importantly, although not extensively discussed herein, if the surviving spouse’s estate, including the QTIP trust, increases over time above the survivor’s Applicable Exclusion Amount (including portability), the bypass trust will almost certainly have saved more in estate taxes than the capital gains tax savings from getting new (presumably mostly increased) basis.[[78]](#endnote-78)

Certainly in some situations a marital trust might generate better basis results than an OBIT. To be more precise, you need to know asset mix, depreciation info, the date of 2nd death, the beneficiary’s distribution needs, tax rates/exclusions, inflation, investment turnover, investment returns and more to make an accurate prediction – all beyond the capability of any mortal being or computer program.[[79]](#endnote-79) The Optimal Basis Increase and Income Tax Efficiency Trust offers the best bet to optimize tax benefits long-term – all of the benefits of the traditional bypass trust but with avoidance of most of the drawbacks.

There will be certain situations in which some of these techniques should not be used. For instance, the common situation in which someone wants to protect the maximum inheritance for children from a prior marriage and severely curtail the spouse’s interest – but even then many taxpayers will prefer variations of some of these techniques (e.g., would a surviving spouse really appoint to his/her creditors to spite the decedent’s kids and is there an independent trustee (or other non-adverse party) on the planet that would consent?).

Some people have been reticent to pay attorneys for needed amendments to planning due to “tax volatility fatigue” and frustration with Congress. The pitfalls and techniques discussed in this commentary, coupled with apparent permanency, should give substantial financial incentives for clients to revisit their estate plan. Moreover, these techniques are simply not available to “do it yourselfers” or general practitioners – there are no off the shelf, Nolo Press or online form books for any of these techniques. However, any attorney specializing in estate planning can adapt these ideas to provide tremendous value to their clients.

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

Ed Morrow

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**CITATIONS:**

1. No trademark claimed, “Super-Duper Charged Credit Shelter Trust” was apparently unavailable [↑](#endnote-ref-1)
2. Section 303 of Public Law 111-312, known as the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 [↑](#endnote-ref-2)
3. Rev. Proc. 2013-15 [↑](#endnote-ref-3)
4. E.g. “AB Trust can be hazardous to your health”, *“Serious tax consequences to AB Trust owners”* “Portability Threatens Estate Planning Bar”, “Is it time to bypass the bypass trust for good?”, readers have probably seen dozens by now [↑](#endnote-ref-4)
5. Frequent *Trusts and Estates* author Clary Redd at May 2011 Advanced Trust Planning CLE, Dayton, Ohio - to be fair, he made this comment before the provision was made permanent. [↑](#endnote-ref-5)
6. $3Million gross gain, assuming $500,000 of gain was realized over time, not counting loss in basis due to depreciation, $2.5 million times a hypothetical 30% combined federal (23.8%) and state (net 6.2%) long term capital gains tax – this may be more if collectibles/gold/1250 depreciation recapture, or if the assets were real estate, one might look at it as depreciation lost and consider the income that could have been offset by the extra basis, which might drive this estimated loss to beneficiaries even higher (though you would have to back out for present value). Of course, if heirs *never* sell the property (and depreciation does not apply) and hold until death, subsequent taxable gains resulting from decreased basis would be non-existent. In short, it’s a rough “guesstimate”. [↑](#endnote-ref-6)
7. An exception would be plans/IRAs that the decedent had previously inherited and was unable to rollover into their own name outright (as surviving spouses typically do) [↑](#endnote-ref-7)
8. For a checklist of reasons why to use a trust and drafting and administration issues to consider if you do name a trust as beneficiary, email the author for CLE outline and checklist. Also, attorney/CPA Sal LaMendola will soon publish a superb comparison of IRA/trust options for second marriage situations in an article to be entitled *Estate Planning for Retirement Plan Owners in Second (or Later) Marriages* [↑](#endnote-ref-8)
9. IRC §121 [↑](#endnote-ref-9)
10. For S Corp qualification, including QSST and ESBT, see IRC §1361 et seq., for small business stock exclusion and rollovers, see IRC §1202 and §1045, for losses on qualifying small business stock see IRC §1244 [↑](#endnote-ref-10)
11. I will avoid the probate/non-probate revocable trust debate, since probate costs and fees will vary from state to state, but probate avoidance and privacy may be yet another reason. A bypass or marital trust might be a testamentary trust. [↑](#endnote-ref-11)
12. A contract to make a will may offer a tempting solution, but there are significant problems with those that exceed the scope of this paper, such as triggering a prohibited transaction as to retirement plan assets or disqualifying assets from marital deduction, not to mention various practical enforcement complexities [↑](#endnote-ref-12)
13. See the Retirement Equity Act of 1984, IRC §401(a)(11), IRC §417(d)(1), Treas. Reg. §1.401(a)(20), Q&A 28 [↑](#endnote-ref-13)
14. Strangely enough, there may be a difference here between a testamentary and living trust. See 42 U.S.C. § 1396p(d)(6); HCFA Transmittal 64 § 3259.1(A)(1) [↑](#endnote-ref-14)
15. See Treas. Reg. §20.2056(c)-2(e) – had John’s will/trust had an A/B split or QTIPable trust with a simultaneous death clause stating that Jane is deemed to have survived him that would have overridden the Uniform Simultaneous Death Act and the IRS would respect the marital trust and hence add enough assets to Jane’s estate to use both exemptions. When the order of death *can* be determined, you cannot simply change the order in the Will/Trust for “surviving spouse” purposes. See *Estate of Lee v. Commissioner*, T.C. Memo 2007-371. If we include a presumption that Jane dies first, will the IRS respect John as a “surviving spouse” for purposes of DSUEA? Probably, but we have no guidance yet. Temporary Regs do not mention this issue. [↑](#endnote-ref-15)
16. *Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir 1992) – decedent’s Will directed that if a QTIP election was not made for a trust that the assets moved to bypass trust with different dispositive provisions. See also Treas. Reg. §20.2056(b)-7(d)(3) “a qualifying income interest for life that is contingent upon the executor’s election under Section 2056(b)(7)(B)(v) [QTIP] will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse.” [↑](#endnote-ref-16)
17. **Example**: John really wishes to leave his $5 million estate to his longtime wife Jane outright (ignoring all the reasons herein for ongoing trusts), but he certainly does not want to lose his exclusion amount, because his wife Jane also has a $5 million estate. His attorney therefore drafts a savings clause in his Will (or revocable trust) that leaves his available exclusion amount to a bypass trust, **but** if a proper estate tax return is timely filed to exploit the DSUEA (and the will/trust provisions may even require this, though this might give up some post-mortem flexibility), the assets instead go outright to his wife to the extent of the election. Thus, if the executor files the Form 706 timely and successfully “ports” $5 million DSUE, then $5 million goes outright. If the executor fails to timely file the Form 706 (or opts out), then $5Million goes into a liberal bypass trust for Jane. Either way, the exclusion is saved.

 An independent executor/trustee may be desired here. A surviving spouse would have obvious conflicts with his or her fiduciary duties to other beneficiaries by filing such an election and potentially gift tax issues as well, unless the filing were mandated in the document. Even if an independent party is named, it may be best to outline parameters or indemnify the executor from diverse ranges of elections selected. Will such a provision be upheld similar to the Clayton case and acquiesced Regulations?

Drafting Example: “I leave my entire residuary outright to my surviving spouse, on the precondition that my personal representative (or my trustee if no personal representative is appointed, pursuant to IRC § 2203) makes an effective election on an estate tax return pursuant to IRC §2010(c) [Section 303 of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010] to grant my wife the use of my Deceased Spousal Unused Exclusion Amount. Should for any reason (intentional or unintentional), such an election is not effectively made, or is made for less than maximum amount available, I hereby leave the maximum amount possible without incurring a federal estate tax to the Bypass Trust described in Paragraph \_\_, and any remaining residuary above this amount shall pass to my surviving spouse outright”. [I hereby indemnify my executor from any such election or failure to elect (be it partial, to the maximum extent or not made at all) made in good faith.] [NB: fractional formula variations on this would be desirable if IRD is involved].

Drawbacks: This technique would be difficult to use for non-testamentary, non-trust assets such as qualified plans, IRAs etc that pay outright rather than through trusts or wills. Imagine trying to draft such language in a beneficiary designation form (and getting it approved by a financial institution!) [↑](#endnote-ref-17)
18. http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P204318- 2% or more jumps happened several times in the late 70s, early 80s. [↑](#endnote-ref-18)
19. IRC §1014(b)(6),(9), (10) [↑](#endnote-ref-19)
20. At IRC §2056(b)(7) and IRC §2056(b)(5) respectively [↑](#endnote-ref-20)
21. Under IRC § §1014(b)(9), not IRC §1014(b)(10) [↑](#endnote-ref-21)
22. Treas. Reg. 25.2518-2(e)(2), (e)(5) Example 5 – also need to check various applicable state laws, since, unless disclaimer is under 2518(c)(3), it has to also comply with state law [↑](#endnote-ref-22)
23. See, e.g. *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999), acq. 1999-2 C.B. 314 [↑](#endnote-ref-23)
24. See, e.g. *Estate of Fontana v. Commissioner*, 118 T.C. 318 (2002), IRS FSA 200119013, interpreting Treas. Reg § 20.2031-1(b), see IRC §754 for inside basis election for partnerhip/LLCs. [↑](#endnote-ref-24)
25. See, *The General Power of Appointment Trust is Back,* Bruce Steiner, LISI Estate Planning Newsletter #2060 (February 6, 2013). [↑](#endnote-ref-25)
26. IRS Rev. Proc. 2001-38, see also PLRs 2009-18014, 2007-29028, 2010-36013, all voiding QTIP election [↑](#endnote-ref-26)
27. The problem with inter-vivos QTIPs is that, after the death of the donee spouse, if assets come back to the donor spouse in trust, even though IRC §2044(c), Treas. Reg. §25.2523(f)-1(f), Example 11 would deem the donee spouse the grantor/transferor for 2036/2038 purposes, under most state laws, the donor spouse is still the settlor, making the trust self-settled and therefore subject to the donor’s creditors despite any discretionary standard or spendthrift provision, and therefore in the donor spouse’s estate indirectly under IRC §2041. See also Rev. Rul 76-103. States that have recently fixed this issue are Arizona (Ariz. Rev. Stat. 14-10505(E)), Michigan (MCL §700.7506(4)), Virginia, Ohio (effective March 27, 2013, Ohio R.C. §5805.06(B)(3)(b)), Delaware (12 Del Code 3536(c)(2), Florida (Fla Stat. 736.0505(3)) [↑](#endnote-ref-27)
28. This is known as a collateral power, See *Restatement Property, Third, Donative Transfers*, §17.3, comment f [↑](#endnote-ref-28)
29. IRC §2041(a)(3), IRC §2514(d). While it’s very simple to add a limited power of appointment (LPOA) that would in theory permit this, understanding the DTT involves what may be uncertain state law and considerable complexity. States such as Michigan and Ohio have recently amended their Rule Against Perpetuities to specifically prevent most unintentional triggerings of the “trap”, but clearly permit intentional triggerings by appointing to a trust that has a presently exercisable *general* power of appointment and therefore triggering IRC 2041(a)(3). See Ohio R.C. §2131.09 (changes effective 3/27/2013), and a comprehensive article on the subject from Attorney James Spica regarding Michigan’s RAP at http://www.michbar.org/probate/pdfs/Summer08.pdf [↑](#endnote-ref-29)
30. A rather clever variation that the IRS fought, lost and finally acquiesced to in *Chisholm v. Commissioner*, 26 T.C. 253 (1956) but beware *Restatement of Property, Second, Donative Transfers* §13.1(c), which would deem any LPOA to be a GPOA if the gift in default of exercise were to pass to the powerholder’s estate.  [↑](#endnote-ref-30)
31. See *Restatement of Property, Second, Donative Transfers*, §13.2 *Creditors of the Donee - Unexercised General Power Not Created by Donee.* If creditor protection is a potential threat, and state law is unfavorable, consider the LPOA/DTT variant. [↑](#endnote-ref-31)
32. Although the author could find no case on retroactive disqualification of either, consider *Estate of Atkinson v. Comm.*, 309 F.3d 1290 (11th Cir. 2002), in which a charitable contribution to an otherwise qualifying CRT was negated by subsequent mistakes in administration years later – even though the charity was not prejudiced. [↑](#endnote-ref-32)
33. In many cases, I would not recommend that an IRA be used to fund a bypass trust, since a spousal rollover has better income tax treatment, but it may be preferable when needed to soak up state estate tax exemption, or for various non-tax reasons. This is mostly included to show the lack of effect on basis on IRD at death. If an accumulation trust (as opposed to conduit trust) design is used, consider a separate or standalone trust so that no broad power to appoint can be construed to apply to the retirement benefits. Blanket savings clauses may not save the stretch, especially since most POAs by default can include non-qualifying trusts. See *Restatement of Property, Third, Donative Transfers* §19.14, other IRA CLE materials developed by author and ¶6.3.09, *Life and Death Planning for Retirement Benefits*, 6th Edition, by Natalie Choate. [↑](#endnote-ref-33)
34. If real estate is held in an LLC/LP or other entity taxed as a partnership, the underlying assets do not automatically get a date of death basis even if the LLC/LP is in the decedent’s estate, but the partnership may make an election under IRC §754 to step up inside basis. Treas. Reg. §1.754-1 [↑](#endnote-ref-34)
35. Potentially, the QTIP may be worse from this perspective if there is no estate tax, since potentially you have discounting if, for instance, a QTIP owns half the home and the surviving spouse owns half – this would allow the heirs less step up in basis than if the surviving spouse had owned the whole. [↑](#endnote-ref-35)
36. Treas Reg. §20.2041-1(b)(3) states that “(3) Powers over a portion of property. If a power of appointment exists as to part of an entire group of assets or only over a limited interest in property, section 2041 applies only to such part or interest.” There are probably dozens of cases and rulings about limiting powers and funding trusts with “caps” a few in the GPOA context are PLR 2001-23045, 2000-101021, 2002-10051, 2004-03094, 2006-04028 [↑](#endnote-ref-36)
37. IRC §1022 [↑](#endnote-ref-37)
38. See IRS Chief Counsel Memorandum (CCM) 200644020, Treas. Reg. §1.1014-4(a)(3), although, in contrast to IRA/see through trust planning with IRD assets, presumably the result here would be less harsh, since assets would get a step up in basis and hence less gain. However, it is best to avoid altogether. [↑](#endnote-ref-38)
39. If the power to withdraw 1/3 had lapsed, 5% might be “lapse protected”, causing slightly less to be in the beneficiary’s estate (and thus less basis adjustment). [↑](#endnote-ref-39)
40. *Restatement, Third, Property, Wills and Other Donative Transfers* §17.1 [↑](#endnote-ref-40)
41. See comment g in §17.1 cited above [↑](#endnote-ref-41)
42. The example did not specify whether the property TIC or LLC shares in trust was 100% or a mere fractional share. I assume here that taking 5/6 of the property is valued at 5/6 of the whole, which might be the case if the trust owned say 40%. If the trust owned 100% or 51% of the LLC, it may apply to a greater number of shares/membership interests. [↑](#endnote-ref-42)
43. See, *Gifts by Fiduciaries by Tax Options and Elections*, November/December 2004 Probate and Property, by Jonathan Blattmachr, Stephanie Heilborn and Mitchell Gans, for a good discussion of gift tax effects of interested fiduciary decisions regarding Clayton QTIPs, investment choices, alternate valuation date, choice of where to deduct expenses and other dilemmas, concluding that independent fiduciaries are generally safer, but citing Treas. Reg. §25.2514-1(b)(1) for apparent safe harbor for investment choices by interested fiduciary. [↑](#endnote-ref-43)
44. Ohio’s former estate tax, eliminated this year, failed to catch the Delaware Tax Trap (R.C. §5731.11), but most states piggy back onto the federal estate. [↑](#endnote-ref-44)
45. IRC §2056(b)(5) – though generally the whole purpose of the OBIT is to avoid forcing the marital, it’s important to remember. This language is also why you can’t simply let 5% of a GPOA lapse every year to let the marital trust escape estate tax altogether after 20 years or so. [↑](#endnote-ref-45)
46. IRC §2041(b)(1) is in the disjunctive “or”. See also *Estate of Edelman v. Commissioner*, 38 T.C. 972 (1962), *Jenkins v. U.S.*, 428 F.2d 538, 544 (5th Cir. 1970) [↑](#endnote-ref-46)
47. IRC §2041(b)(1)(C)(ii), Treas. Reg. §20.2041-3(c)(2) [↑](#endnote-ref-47)
48. To be adverse, the party must have a “substantial interest in the property subject to the power which is adverse to the exercise of the [GPOA]”. An independent bank co-trustee, for example, is not sufficiently adverse. *Estate of Vissering v. Commissioner*, 96 T.C. 749 (1971), reversed on other grounds, *Estate of Jones v. Commissioner*, 56 T.C. 35 (1971), *Miller v. United States*, 387 F.2d 866 (1968). [↑](#endnote-ref-48)
49. Treas. Reg. §20.2041-3(b) [↑](#endnote-ref-49)
50. See PLR 2012-03033, and discussion thereof in separate IRA “see through trust” checklist CLE materials developed by author. This PLR addressed the effect of such a limitation for “see through trust” purposes of identifying the oldest beneficiary applicable, but it did not discuss whether after such a limitation the power was still a GPOA. Pursuant to the plain language of the statute and Regs, it still is, but at some point you have to wonder whether the IRS would argue it is illusory – how many creditors out there are young individuals? However, the vast body of case law and regulations bend over backwards to find GPOAs. Like horseshoes and hand grenades, you only have to be close – if you give a mentally incompetent person a GPOA they don’t even know about, it’s still a GPOA for tax purposes. One related area the IRS has fought related issues is in the *Crummey* and *Cristofani* present interest cases, where the IRS insists on a GPOA powerholder’s knowledge for there to be a present interest (Rev. Rul. 81-7) – but they consistently lose cases in this area even with shoddy trust administration. [↑](#endnote-ref-50)
51. IRC §1014(c), IRC §691 [↑](#endnote-ref-51)
52. Otherwise, a powerholder could simply borrow $1 from anyone and/or promise to pay unlimited amounts in exchange for some peppercorn of consideration to attempt to enable an appointment of all the assets to whomever they wished. However, such shenanigans to circumvent the class of appointees may be voided as a “fraud upon the power”, see *Restatement of Property, Third, Donative Transfers,* §19.15, §19.16 [↑](#endnote-ref-52)
53. See *Restatement of Property, Second, Donative Transfers*, §13.2, §13.4 (state law), §13.6 (bankruptcy, which could be applicable if decedent was in bankruptcy prior to death) – best to check those for citation to your individual state law. If your state law is unfavorable, it may be preferable to use the Delaware Tax Trap technique, which uses *limited* powers of appointment only. [↑](#endnote-ref-53)
54. See also Treas. Reg. §20.2041-3(e) [↑](#endnote-ref-54)
55. *Using the Delaware Tax Trap to Avoid Generation Skipping Transfer Taxes*, Johnathan Blattmachr and Jeffrey Pennell, 68 Journal of Taxation 242 (1988), <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954062>. While the DTT was not considered or discussed for this type of planning, this is not the fault of two of the sharpest estate planning minds in the country, rather, the exclusion was only $600,000 at the time. See also *A Practical Look at Springing the Delaware Tax Trap to Avert Generation Skipping Transfer Tax*, James P. Spica, 41 RPTL Journal 167, Spring 2006; *The* *Delaware Tax Trap and the Rule Against Perpetuities*, Stephen Greer, Estate Planning Journal Feb 2001. [↑](#endnote-ref-55)
56. See discussion in articles in above footnote, specifically Footnote 17 in Pennell and Blattmachr’s article cited above, wherein they opine that this would trigger the DTT under most states’ RAP. [↑](#endnote-ref-56)
57. Contrast presently exercisable GPOAs in *Restatement of Property, Second, Donative Transfers*, §13.2 and §13.5 with the testamentary variations in §13.4 (state law), §13.6 (bankruptcy). Testamentary or Lifetime GPOA makes a difference in bankruptcy. See 11 U.S.C. § 541(a)(1). No cases discussed in the above Restatement cases discussed the impact of a non-adverse party’s consent, notice or other prerequisite’s impact on creditors’ rights. [↑](#endnote-ref-57)
58. IRC §1014(b)(6) [↑](#endnote-ref-58)
59. Alaska Statute § 34.77.100 et seq. for how one may elect into community property treatment for low basis assets using an Alaska Community Property Trust (and avoid such treatment for problematic assets such as IRAs or assets with higher basis than FMV). See, *The Tax Advantages of Using Joint Revocable Trusts and Alaska Community Property Trusts in Common Law Property States*, <http://shaftellaw.com/article15.html>, *Alaska Enacts an Optional Community Property System which Can be Elected by Both Residents and Nonresidents,* by David Shaftel and Stephen Greer,<http://shaftellaw.com/article3.html>

Blattmachr, Zaritsky and Ascher, *Tax Planning With Consensual Community Property: Alaska's New Community Property Law*, 33 Real Property, Probate and Trust Journal 615 (1999).

Disclosure: the author’s employer, KeyBank, has trust powers and operations in Alaska. [↑](#endnote-ref-59)
60. See PLRs 2000-101021, 2002-10051, 2004-03094, 2006-04028 – nutshell: giving poorer spouse a GPOA over assets of richer spouse that could fund a bypass trust for richer spouse at poorer spouse’s death. In most cases the richer spouse would be better off funding an inter-vivos QTIP, transferring non-controlling LLC interests or other intervivos gift-splitting to harvest a poorer spouse’s GST exclusion. Notably, most practitioners including this author believe those rulings are incorrect in their holding that transfers from richer spouse to poorer spouse’s estate qualify for the marital deduction under IRC §2523. See Clary Redd’s article *Sharing Exemptions? Not So Fast,* Trusts and Estates, April 2008*.* However, other aspects of those rulings are non-controversial, and include the idea of capping a GPOA to an amount able to be soaked up by an appointee’s available applicable exclusion amount – a key feature in this article that the IRS seems to have no problem with. [↑](#endnote-ref-60)
61. Uniform Trust Code §505(b) [↑](#endnote-ref-61)
62. It’s great for very large estates, if you use a state with appropriate intervivos QTIP protections, see Jonathan Blattmachr, Mitchell Gans and Diana Zeydel’s Supercharged Credit Shelter Trust article at <http://eagleriveradvisors.com/pdf/The-Supercharged-Credit-Shelter-Trust-A-Super-Idea-for-Married-Couples.pdf>. See Footnote 27 for citations to state law in this area. [↑](#endnote-ref-62)
63. Treas. Reg. §1.671-2(e)(5), Example 9 [↑](#endnote-ref-63)
64. Ohio RC §5805.06, effective 3/27/13, “intended to be a statement of the common law of this state” [↑](#endnote-ref-64)
65. *Commissioner v. Estate of Bosch,* 387 U.S. 456 (1967) held that a state trial court decision as to an underlying issue of state law should not be controlling when applied to a federal statute, that the highest court of the state is the best authority on the underlying substantive rule of state law, and if there is no decision by the highest court of a state, then the federal authority must apply what it finds to be state law after giving “proper regard” to the state trial court’s determination and to relevant rulings of other courts of the state. It does not say to ignore state law, as some practitioners fear. For one of several cases denying the marital deduction for attempts at a post-mortem “fix” or relying on marital savings clauses, see *Estate of Rapp*, 130 F.3d 1211 (9th Cir. 1998) [↑](#endnote-ref-65)
66. Although taxpayers can argue that September 30 of the year after death should be the important date to “fix” a see through trust by, and I would still argue this in clean up mode, the IRS could argue that, except for disclaimers that “relate back”, the Code and Regulations require there to be a beneficiary named by the owner/employee pursuant to the terms of the plan and/or default under agreement to obtain status as a “designated beneficiary” at the time of death, and if the trust changes terms significantly after that, it is arguably not the same beneficiary post-reformation that it was at the time of death, hence no DB, even if effective for non-tax law. IRC §401(a)(9) and Treas. Reg. 1.401(a)(9)-4, A-1. See PLRs 2002-18039, 2005-22012, 2005-37044, 2006-08032, 2006-20026, 2007-03047 and 2007-04033 (allowing reformation to affect tax result at death for IRA/trust), and PLRs 2007-42026, 2010-21038 (contra). [↑](#endnote-ref-66)
67. Rev. Rul. 73-142 [↑](#endnote-ref-67)
68. Treas. Reg. §20.2041-1(b)(1), Rev. Rul. 95-58 [↑](#endnote-ref-68)
69. PLR 2005-43037 [↑](#endnote-ref-69)
70. IRC § 2514 [↑](#endnote-ref-70)
71. PLR 2011-32017 [↑](#endnote-ref-71)
72. IRC §643(a)(3), Treas. Reg. §1.643(a)-3(a) [↑](#endnote-ref-72)
73. This should not cause estate inclusion, nor a taxable gift, if it is properly circumscribed with support obligation savings clauseprovision to forbid distribution to someone whom the donee powerholder owes an obligation of support. See Treas. Reg. §20.2041-1(c)(1)(B). It could trigger a gift if exercised so as to trigger the Delaware Tax Trap, discussed elsewhere herein. IRC §2514(d). [↑](#endnote-ref-73)
74. See IRC §642(c)(1) and Regs. The Supreme Court held in *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937) that “pursuant to the governing instrument” in IRC §642(c) plainly includes discretionary distributions, and need not be pursuant to a mandatory direction. There is some uncertainty, however, from narrower lower courts, and how this may play out using POAs rather than distributions from the trustee pursuant to a spray provision. Generally, you would be more secure in getting the 642(c) deduction the more direct, certain and specific the trust provision is. See discussion of 642(c) nuances in Chapter 6.08 of *Federal Income Taxation of Trusts, Estates and Beneficiaries* by Ascher, Ferguson, Freeland. It is questionable whether a POA can even carry out *income*, since it is a power over specific *property*, so it is quite different from a spray provision. However, a lifetime LPOA has efficacy as both a backstop and threat to the trustee’s spray power and as an alternative method of transferring property subject to differing tax results. If the powerholder is a mandatory income beneficiary however, it would be deemed a gift of the lost income, and if the powerholder also has a testamentary GPOA it would be considered a gift as well. *Estate of Regester*, 83 T.C. 1 (1984), Treas. Reg. §25.2514-1(b)(2). This may not be fatal, but for these reasons as well as income tax planning, an independent trustee’s spray power over income and principal should be preferred over using lifetime LPOAs. [↑](#endnote-ref-74)
75. Treas. Reg. §1.642(c)-1(a)(2) [↑](#endnote-ref-75)
76. Treas. Reg. 1.642(c)-3(b)(2), and Ex. 2 [↑](#endnote-ref-76)
77. Thresholds for single and married filing jointly couples to incur the top 39.6% and 20% long-term capital gains and qualified dividends rates [↑](#endnote-ref-77)
78. For the wealthy, a QTIP bequest with full DSUEA elected and reverse QTIP election would probably always beat a standard bypass trust for wealthy married couples if the surviving spouse then immediately funded via gift a maximum (e.g. $10.5 million in 2013) irrevocable grantor trust (or released a portion of the QTIP to trigger IRC §2519). This could then potentially exploit installment sales, swaps, etc. Using intervivos QTIPs or grantor trusts funded via gift after the first death enable the use of pre-estate tax dollars to pay the income tax burden of the grantor trust. This will work, at least until the Obama Administration closes the grantor trust “loophole” per its 2013 Greenbook proposals (page 83). Most couples of such wealth have already used the gift tax exclusion during their lifetime, but those who haven’t should strongly consider that technique. [↑](#endnote-ref-78)
79. For illustrations of this savings if investment returns net approximately 11% and the surviving spouse lives 15 or 30 years, see Gassman, Crotty, Buschart & Moody *On the $28,000,000 Mistake: Underestimating the Value of a Bypass Trust and Overestimating the Value of Spousal Estate Tax Exclusion Portability,* Steve Leimberg's Estate Planning Newsletter #2061. While I may disagree a bit with some of the assumptions, the general thrust of the article/spreadsheets is in the right direction and makes a powerful point. [↑](#endnote-ref-79)