Estate and Tax Planning Roadmap for 2019-2020

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Estate and Tax Planning Roadmap for 2019-2020

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Introduction

Tax reform at the end of 2017[1] (the "2017 Act") changed the planning landscape.[2] While many clients and even practitioners see little need for estate tax minimization planning in light of the high exemptions, others see an opportunity to shift wealth, implement asset protection strategies utilizing the higher exemptions, and so forth. There was also a marked shift in planning discussions from estate tax to income tax, although it is less clear as to how much actual planning, utilizing non-grantor trusts for an array of income tax planning benefits has occurred. The changes to planning were, in some instances profound, with practitioners having to craft completed gift trusts that were able to secure the benefits of the high temporary exemption, non-grantor status for state and local tax ("SALT") or other benefits, while still preserving access to the trust assets given the size of the exemption relative to the net worth of even wealthy clients. These seemingly contradictory goals required rethinking many aspects of trust planning and drafting. In addition to the use of non-grantor trusts described above, it has become common to change what had been the traditional "A-B" trust dispositive scheme to a plan bequeathing assets to a marital trust that could be disclaimed, or transferred via a Clayton election, to a credit shelter disposition, to facilitate the possibility of obtaining a second basis step-up on the death of the surviving spouse. Some have added clauses to credit shelter trusts to enhance the flexibility to shift assets back into the estate to obtain a basis step-up. The use of general powers of appointment to cause trust assets to be included in the client's estate, or the estate of an older generation family member whose estate is less than the exemption (so-called "upstream" planning), has also become common.

With a possible shift of control in Washington on the horizon, various demographic trends, and increasing elder financial abuse, the challenges have become ever more complex. This article will explore various planning strategies that practitioners may employ to help clients capitalize on the estate tax environment created by the 2017 tax act, with consideration of these newer developments and trends.

In this world of constant uncertainty, only one thing is clear, planners need a roadmap in order to be successful in crafting strategies to preserve and protect their clients' wealth.

What follows is a discussion of a wide range of planning considerations in this challenging planning environment. Some of the planning points in this article have been adapted from several prior LISI newsletter and other articles and presentations.

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[1] Tax Cuts and Jobs Act of 2017 (the Act) (more formally referred to as "An Act to provide for reconciliation pursuant to titles II and V of the concur- rent resolution on the budget"), Public Law 115-97, Dec. 22, 2017.

[2] See Shenkman, Blattmachr and Matak, "Tax Cuts and Jobs Act: Impact on Estate Planning and Ancillary Planning Areas," LISI Estate Planning Newsletter #2612 (December 22, 2017); Shenkman and Blattmachr, "Trust Planning after the New Tax Law," Trusts & Estates, Feb 2018, p. 13.

Use Consent Dividends to Avoid PHC Tax

The 2017 Act ushered in a new low 21% federal corporate tax rate and a rush to convert to C corporation status soon followed. With a corporate rate of 21% and the maximum federal individual rate at 37% (or, 40.8% if the 3.8% NIIT under Section 1411 is applicable), there is now a significant incentive to organize or convert to a C corporation and hold cash and investment assets inside the entity, rather than make distributions to individuals. Many taxpayers have modified existing entities into C corporations or have created new entities as C corporations instead of other forms of entities.

The PHC tax, imposed under Section[3] 541, was enacted decades ago, at a time when the marginal corporate tax rate was well below the individual top income tax rate. The purpose of the PHC tax was to prevent taxpayers from accumulating income inside a C corporation at a lower tax rate. The PHC tax had remained largely irrelevant for many years because corporate tax rates exceeded the top individual tax rates, making it unwise to accumulate income within the C corporation. The Tax Cuts and Jobs Act of 2017 turned the tables and breathed new life into the PHC tax.

The PHC tax is assessed under Section 541, which provides:

> "541 - Imposition of personal holding company tax -In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 20 percent of the undistributed personal holding company income."

The aggregate of the 20% PHC rate and the regular corporate rate of 21% is 41% (and higher if income tax (and possibly the NIIT) is imposed on dividends to shareholders from the C corporation).

The PHC tax is imposed on personal holding company income ("PHCI"), which is calculated by taking specified deductions from the C corporation's income. PHCI may include the following (but there are a host of exceptions and special rules): dividends, rents, mineral, oil and gas royalties, amounts received from contracts for personal services, income reported by a corporate beneficiary of an estate or trust, etc.

A personal holding company must meet both an income and ownership test for the tax to apply. The income test requires that not less than 60% of the corporation's adjusted ordinary gross income for the year be comprised of PHCI. The ownership test requires that, for the last half of the tax year, more than 50% of the stock is owned directly or indirectly by five or fewer individuals. Constructive ownership rules apply to attribute to a particular shareholder those shares in the C corporation that are owned by controlled entities, etc. Section 544. This may result in the aggregation of shares transferred to various types of trusts used in estate planning.

[3] All references in this article to "Section" is to a section of the Internal Revenue Code of 1986 as amended ("IRC")

If the C corporation meets the income and ownership tests, it could be subject to an additional 20% PHC tax. Consider, while planning, avenues to avoid or else risk failing the ownership or income test. For example, a C corporation could buy a business that produces such significant gross income that will enable the post-sale corporation to fail the 60% of income test. If a C corporation meets both tests, since PHCI is reduced by dividends paid, the corporation may be able to pay a "late" dividend (known as a "deficiency dividend") to its shareholders in order to reduce the PHCI and thereby purposely fail the income test which could eliminate the PHC tax. See Section 547.

A late dividend "election" is made by filing with the Form 1120 "U.S. Corporation Income Tax Return":

- Schedule PH.
- Form 972 – "Consent of Shareholder to Include Specific Amount in Gross Income".
- Form 973 – "Corporation Claim for Deduction for Consent Dividends."

The IRS granted a C corporation an extension on the period of time during which it could make the election to pay a consent dividend and avoid the PHC tax.[4] This may be important for other taxpayers, and their advisers, grappling with the new planning environment post 2017 Act.

The IRS granted the C corporation a 60-day extension to make the election for a consent dividend under Section 565 (which permitted the corporation a deduction for such dividends). The rationale for the leniency was that the corporation made reasonably good faith reliance on its accountant who had not properly advised the entity. The accountant had evaluated the corporation's PHC tax at the consolidated return level and concluded that PHC tax did not apply. The accountant failed to advise the taxpayer that it was necessary to make the consent dividend election.

Until limited liability companies ("LLCs") became ubiquitous in planning, the use of S corporations was common in the context of family transactions. S corporations, unlike C corporations, permit the flow through of income to the shareholders. However, they are subject to a number of stringent restrictions which often constrained estate planning, e.g. only specified trusts may hold S corporation stock, there can only be a single class of stock (although voting and non-voting shares are permitted), etc. While C corporations may have become more popular because of the new favorable tax break, that is unlikely to reduce significantly the number of S corporations involved in family estate and other plans. However, practitioners need to be alert for the unique tax considerations that C corporations might require. In addition, estate planners would be well advised to consider the implications that the restructuring of another type of entity into a C corporation may affect: buy-sell agreements, terms of trusts, succession planning, and the other "ripple effects" that might occur.

[4] Private Letter Ruling 201901002.

Reconsider Existing and Future Trust Planning in Light of the Broader Implications of *Kaestner*

The *Kaestner* case[5] has already been discussed extensively in the professional literature. While we will not delve into the specifics of the case or provide a recitation of the facts, it is important to identify certain points raised by the Court, in its opinion, which might inform decisions that may be useful to practitioners in structuring future trust planning in light of *Kaestner*.

The Supreme Court made clear that its decision in *Kaestner* was specifically limited to the facts and circumstances of that case. Instead of settling the matter of whether it is acceptable for a state to tax a non-grantor trust based on the residency of the beneficiary, the Court merely identified facts that would not allow a state to tax a trust based on the beneficiary's residency. Specifically, the *Kaestner* Court was particularly persuaded that a trust should not be taxed as a North Carolina resident trust solely on the basis of the beneficiary's residence where the beneficiary had no control over the assets of the trust, could not demand any trust income, and did not actually receive any income from the trust during the years in question.

- **Decant trusts with mandatory distributions.**
  Given the Court's emphasis on the beneficiary's inability to demand distributions, practitioners may consider decanting trusts, when terms of the instrument and governing law permit, to make the trust wholly discretionary.

  The holding in *Kaestner* might suggest that a state may tax a trust based on the beneficiary's residency where the beneficiary can demand a distribution of the greater of 5% of the corpus of the trust or $5,000, as described more specifically in Section 2514(e).

  The *Kaestner* decision might be construed to suggest that North Carolina, or any state with a similarly worded statute, might be able to tax any trust that requires distributions for health, education, maintenance and support (a so-called HEMS standard). Even a trust with an independent trustee could cause a state income tax under *Kaestner* because the beneficiary is eligible for distributions under a definite standard.

  A state may be able to tax a trust where a beneficiary is entitled to distributions on the achievement of certain ages or milestones, under the holding in *Kaestner*.

  In each of these circumstances, the safer course may be to decant the trust into one that only permits discretionary distributions as determined by an independent trustee and does not provide for distributions at any specified age.

- **Consider judicial modification without beneficiary approval**

[5] On June 21, 2019, the Supreme Court of the United States published its decision in *North Carolina Department of Revenue v. Kimberley Rice Kaestner* 1992 Family Trust, 588 U. S. ____ (2019) (*Kaestner*). This portion of this article is adapted from an article on the case scheduled to appear in Estate Planning magazine.

The trust at issue in the *Kaestner* case had been previously decanted from a trust that terminated at a specified age. Consider whether effectuating a non-judicial modification to curtail beneficiary control might taint the result as evidencing beneficiary control (in contrast to a decanting effectuated by the trustee). If the beneficiary must consent (or, at least, not object) to a non-judicial modification, might a court view that as the beneficiary actively participating in or controlling the decision? In contrast, it might be possible for decanting to be effectuated by the trustee with no beneficiary involvement.

- **Avoid making distributions**

  If possible, avoid making distributions to a beneficiary who resides in a state where such a distribution would trigger an undesired state income tax. For example, assume that a state determines taxability of the trust based on the residency of the beneficiary. The terms of the trust may permit loans to the beneficiary, which may address short-term cash needs. Any loans must carry adequate interest and be memorialized with appropriate documentation which evidences an intent on the part of the beneficiary to pay the loan back. Actual payments by the beneficiary to the trust may be needed. The loan may need to be secured by the beneficiary's property. The trust should not make regular or periodic loans to the beneficiary that look more like distributions than loans.

  Alternatively, there may be opportunities for the trust to make payments on behalf of the beneficiary without causing taxability of the trust in the state of the beneficiary's residence. By way of example, if the trust were to acquire a property outside the beneficiaries' home state and allow the beneficiary to live in it, this would not necessarily cause the trust to be taxable under the state law at issue in *Kaestner* (though it may cause inclusion if the property were located within the state).

  Theoretically, if a person in a non-fiduciary capacity directed the trustee to transfer funds from the trust to a named person, pursuant to a power of appointment, such a payment may not be deemed a "distribution" and the recipient might not be deemed a "beneficiary" in a traditional sense because, generally, only a fiduciary can make distributions to a beneficiary. It is unclear how the taxability of the trust in this case would be determined under the *Kaestner* holding.

- **Choose an institutional trustee in a tax-friendly jurisdiction**

  The residence of individual trustees is a crucial factor in determining a state's ability to tax income of a trust. In the *Kaestner* case, no trustee lived in North Carolina. Consider choosing an institutional general trustee based in a tax friendly jurisdiction in lieu of a friend or family trustee in the taxing jurisdiction. Doing so could be helpful in avoiding state taxation.

  It may prove much less costly to pay an institutional trustee to serve as trustee in a state with no tax. This is particularly so because such an institutional trustee can ensure that the trust adheres to formalities that could bolster the trust's defenses against a challenge by a beneficiary's state attempting to tax the trust's income.

Even if the trust has named an institutional trustee to serve as trustee, there are still some ways to allow family members to participate in the administration of the trust:

1. Ensure that the family member is not a resident of a jurisdiction where such residency would be used to create a state tax which would not otherwise be owed by the trust and name that person as Trust Protector.

2. Give such person the power to act in a non-fiduciary capacity.

3. Organize an LLC in a tax-friendly jurisdiction. Name the LLC as trust protector and outline the specific powers and responsibilities such entity would have over the trust. Identify one or more family members to serve as manager(s) of the LLC, with the power to make decisions on behalf of the LLC.

It would seem that taking these extra steps – and adhering to the rules established by the forum– may avoid state income taxation of the trust.

- **Avoid certain contacts with the taxing jurisdiction**

In the *Kaestner* case, the Court pointed out that the trust lacked several contacts with North Carolina. Though it was not entirely clear that the holding of the case hinged on the lack of these contacts, a safer course for any trust seeking to avoid state taxation would be to take note of these points:

1. In *Kaestner*, the trust records were physically located outside of North Carolina. It is not clear whether this inquiry will continue to be relevant in the modern digital age. In any event, *Kaestner* makes clear that a trustee should not store physical records in the taxing jurisdiction whose authority to tax is trying to be avoided.

2. Trust asset custodians were located in a state other than the taxing state in *Kaestner*.

3. The trustee should also engage investment advisors physically located outside of the taxing jurisdiction and also prefer advisors which do not have locations within the jurisdiction if possible.

4. The trust should avoid renting or owning an office in the taxing state.

5. The trust should avoid owning real property or tangible personal property in the taxing state. Therefore, if the trust acquires property for the beneficial use of a beneficiary, consider dividing the trust so as to avoid tainting the entire trust corpus for taxation purposes.

6. The trust should not have any direct investments in the taxing state. Some states take the position that any active business in their state will taint the entire income of the trust as taxable. If that situation affects a trust, consideration may be given to dividing the trust. Many trust documents permit the trustee to divide the trust for a variety of reasons. If not, state law might permit division. If that isn't the case, decanting may provide another possible way to cure this state tax issue.

7. The number of meetings between the trustee and beneficiary may be relevant. The Court noted: "the trustee's contacts with *Kaestner* were 'infrequent.'" Therefore, consider having beneficiary meetings in a tax neutral location.

Aging and Longevity

Factor Life Expectancy of Wealthy Clients into Financial and Estate Planning Decisions

"Men in the top one-fifth of America by income born in 1960 can on average expect to reach almost 89, seven years more than their equally wealthy brethren born in 1930. (Life expectancy for men in the bottom wealth quintile remained roughly stable at 76.)" [6]

Consider what the above longevity statistics mean to planning. Using table life expectancies will understate actual life expectancy for the wealthy clients almost all advisers serve.

Also, in the discussion of societal goals and the estate tax, the shocking statistics of expanding life expectancy for the wealthy and stagnant life expectancy for the lower tiers of wealth may well serve as an incentive for the proposals of universal health care to be paid for by a harsh estate tax. Many Americans believe the wealthy should pay more tax. If the difference in life expectancies becomes more widely known, it may only serve to fuel the desires of many Americans to address wealth disparity through tax law changes, etc.

What might this mean to future tax and other legislation? What proactive steps might wealthy clients take now? Is this yet a further reason wealthy clients should plan more aggressively now before changes in the law occur (see discussion of Sanders' bill below)? If wealthy clients live substantially longer than table life expectancies that should be factored into plan design? For example, it may be feasible to use longer GRAT or note terms as a part of a plan.

Proactively Help Clients Plan to Protect Themselves from the Elder Financial Abuse Epidemic

The statistics on elder financial abuse may be dramatically worse than many have believed.

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[6] Simone Foxman, "U.S. Billionaires Are Living Longer Than Ever, Making Heirs Wait," Apr 3, 2019, Bloomberg, https://www.wealthmanagement.com/high-net-worth/us-billionaires-are-living-longer-ever-making-heirs-wait?NL=WM-07&Issue=WM-07_20190408_WM-07_984&sfvc4enews=42&cl=article_6_b&utm_rid=CPG09000005740948&utm_campaign=19709&utm_medium=email&elq2=d0c17deacd1a4f95910e5e559dc3c857

- "Senior citizens may lose nearly 25 times more to scammers than what is reported, according to a report by Comparitech, a consumer research organization based in the U.K. Instead of the 200,000 cases of elder financial abuse that are reported annually to U.S. authorities, the actual number may be as high as 5 million, with losses of $27.4 billion a year, not the $1.17 billion that is officially reported." [7]
- "A lot of the financial abuse is perpetrated by family members or people the elderly trust, so they are reluctant to report it; they may be ashamed they got scammed, or they may not realize it…"
- "Statistics on the real numbers surrounding elder financial abuse vary by organization, but experts agree it is a serious problem that is debilitating to seniors. An earlier report from the New York City Department for the Aging and Cornell University done in 2011 estimated that only one in 23 cases is reported."
- "Comparitech estimated one in 10 people in the United States over the age of 65 fell victim to elder fraud in the last year.

The impact of undue influence and other forms of elder financial abuse are staggering. Traditional estate planning in many ways still seems mired in the historic view of intact families in first marriages and family loyalty that in many situations is inappropriate or simply does not exist. The common approach of naming a spouse then children in age order as agents, perhaps, should be discussed in detail with clients along with other planning options.

Clients are aging and the incidence of elder financial abuse, and the permutations it can take, are growing as well. A recent article illustrated what appears to be a common occurrence that it dubbed "inheritance exploitation:"[8]

> "After a live-in caretaker was hired to care for his mother full-time, the woman's step-son and other family members were allegedly denied access to their loved one, locked out of the family home and written out of estate planning documents that had originally named them as heirs. By the time the step-son sued for breach of fiduciary duty and financial elder abuse, the caretaker had already pocketed some $5 million, according to a lawsuit filed in the Superior Court of California in Alameda. Although the case against the caretaker was privately settled in mediation last month, the attorney for the plaintiffs, Michael Hackard, warned that cases of inheritance exploitation like this one are on the rise."

The statistics of those potentially at risk is alarming: "The number of boomers in their 60s with living parents has risen since 1998 to about 10 million, according to an Urban Institute analysis of University of Michigan data. The Alzheimer's Association estimates that 5.8 million Americans are living with Alzheimer's."[9]

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[7] Karen Demasters, "Elder Financial Abuse Much Worse Than Reported, Study Says," Financial Adviser, Apr 19, 2019, reporting data from Comparitech, a consumer research organization based in the U.K.

[8] Juliette Fairley, "What Advisors Can Do About Inheritance Exploitation," Financial Adviser, February 25, 2019 https://www.fa-mag.com/news/what-advisors-can-do-about-inheritance-exploitation-43495.html?section=101&page=2 .

[9] Apr 16, 2019. Alzheimer' s Disease Questions and Answers https://dshs.texas.gov/alzheimers/qanda.shtm

All advisers should become more knowledgeable about helping protect aging, ill or otherwise at-risk clients. There is no question that wealth advisers, as well as other practitioners, can serve a vital role in protecting clients with these challenges, but to do so more may need to be done then typically occurs. Addressing how that role can be enhanced, and the role of other advisers on the planning team, can reduce the risks of "inheritance exploitation" and elder financial abuse generally.

Practitioners may need to prioritize longevity planning with safeguards to minimize the risks of elder financial abuse. By way of example, when preparing a durable power of attorney, consider how the instrument might be drafted to hedge against elder abuse without sacrificing the effectiveness of the power. Perhaps a revocable trust with a trust protector and co-trustees might provide a better set of checks and balances. Consider including restrictions on amendment and major withdrawals under certain defined circumstances in the absence of court approval.

In any event, even the most well-drafted power of attorney and revocable trust is no replacement for a coordinated team of independent experts: an attorney, CPA, wealth advisor, insurance agent, etc. if each is provided access to financial information that could permit them to ring the alarm should they see suspicious activity.

Financial professionals can restrict distributions from accounts if they have a reasonable belief that the client/account owner is being subjected to financial exploitation under FINRA Rule 2165. The FINRA rule also appropriately broadens the discussion to include not just elderly clients (which most articles unfortunately restrict their discussion to) but clients with other health or cognitive challenges that make them susceptible to abuse. Under FINRA Rule 2165(a)(1) "…the term 'Specified Adult' shall mean: (A) a natural person age 65 and older; or (B) a natural person age 18 and older who the member reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interests."

FINRA now permits placing a temporary hold on disbursements from the accounts of customers who are believed to be at risk. This may occur when "[t]he member [financial adviser] reasonably believes that financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted; and the member, not later than two business days after the date that the member first placed the temporary hold on the disbursement of funds or securities, provides notification orally or in writing, which may be electronic, of the temporary hold and the reason for the temporary hold to: (i) all parties authorized to transact business on the Account, unless a party is unavailable or the member reasonably believes that the party has engaged, is engaged, or will engage in the financial exploitation of the Specified Adult; and (ii) the Trusted Contact Person(s), unless the Trusted Contact Person is unavailable or the member reasonably believes that the Trusted Contact Person(s) has engaged, is engaged, or will engage in the financial exploitation of the Specified Adult; and… [T]he member immediately initiates an internal review of the facts and circumstances that caused the member to reasonably believe that the financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted. (2) The temporary hold authorized by this Rule will expire not later than 15 business days after the date that the member first placed the temporary hold on the disbursement of funds or securities, unless otherwise terminated or extended by a state regulator or agency of competent jurisdiction or a court of competent jurisdiction, or extended pursuant to paragraph (b)(3) of this Rule."[10]

To best equip a financial adviser to provide this safety net, a number of prerequisites need attention. The adviser must have names and contact data for trusted contact persons whom they might contact if concerns arise. There are many more practical steps that can be taken that too often are not addressed in the planning process, whether because clients are reluctant to address these difficult personal issues or they simply are not raised for consideration during the planning process. Many of these steps are non-technical practical steps that the client's planning "team" might foster. Often these steps are not within the primary purview of any single adviser and are not the traditional planning steps most advisers take. To combat the growing epidemic of financial abuse of elderly and infirm clients, more may be required.

- Perhaps a key step is changing the dialogue. There does not seem to be nearly enough focus in financial and estate planning discussions on later life planning; nor does there seem to be a collaboration amongst different professionals robust enough to foster a true team effort in this regard. Because FINRA does not mandate that an advisor seek a restraining order to preclude a questionable transaction, it can be helpful if other advisors receive authorization to alert other trusted individuals who might have authority to take steps to protect the client. Regular meetings that involve all concerned advisers who are engaged in various disciplines and have varying perspectives can be an important step in identifying and mitigating risks, perhaps even before abuse occurs.
- Many clients have many accounts scattered at many institutions. This makes each account less significant to the financial adviser at each firm. This can exponentially increase the number of accounts at different institutions making identification of an issue more difficult. To protect against elder abuse, it may be safer to consolidate accounts at one or two institutions and deepen the relationship with the adviser at the firm (or if necessary a limited number of firms) so that the adviser has more contact, more knowledge and hence more opportunity to identify and react to potential elder abuse. This can be a difficult or impossible task for a financial adviser to accomplish because the client may view the recommendation to consolidate accounts with that adviser as self-serving. However, if the client's other advisers encourage consolidation (e.g. the CPA or estate planning attorney) that recommendation may have more impact.
- Get a real financial plan based on a realistic budget completed by a CPA and/or financial adviser. This may provide a touchstone to evaluate suspect transactions. Without a budget and financial plan, only the most egregious distributions might be identifiable as suspicious. For example, a wire transfer of $100,000 to a Caribbean account pertaining to a supposed lottery winning might be identifiable in all instances (if someone is paying attention). However, if a care worker or family member were to take an elderly client to the cash ATM machine several times a week and slowly pilfer money in that manner, would that be noticeable? Perhaps, not without a budget to compare to historic cash withdrawals. Too many people do not address the fundamental basics of planning which are critical to protecting clients as they age or deal with other health challenges.

[10] Regulatory Notice 17-11, https://www.finra.org/sites/default/files/Regulatory-Notice-17-11.pdf Mar 11, 2017.

- Automate financial transaction when feasible. If most bills are automatically charged to credit cards, credit cards automatically paid from a checking account, and deposits automatically made to the same account a number of protective benefits can be achieved. First, the number of bills, checks and other financial records that arrive by mail can be drastically reduced. That leaves less information for bad actors to abuse. Also, automating financial transactions reduces the amount of work necessary to pay bills and make deposits, thereby permitting more attention to be given to oversight then working in the financial weeds. In any event, a review of the credit card statements remains advisable, especially if the card becomes accessible to care providers or other individuals. Online shopping and food, clothing and gas charges made by others for their personal benefit may be difficult to identify as inappropriate.[11]
- Second, automate accounting records on a computer program (e.g. Quicken), so that a CPA or other independent or trusted person can monitor activity remotely. Consider if feasible having an independent firm (e.g. a CPA firm) handle bill payments. That can provide a check and balance and independent oversight. It also creates the foundation for a trustee, wealth advisor and/or CPA to step into help with, and eventually take over, bill payment and similar functions.
- Encourage clients to use a more robust revocable trust in lieu of relying on a durable power of attorney. Powers of attorney often have one person named as agent to act on behalf of the client. That can foster financial abuse if the agent is the person who turns out to be the bad actor. A revocable trust can offer a number of safeguards. For example, you can incorporate co-trustees. While this can be done in a durable power of attorney (and perhaps should be), other steps in a trust may include appointing a trust protector. This is a person, who may be designated to act in a fiduciary capacity (and under some state laws fiduciary status is the only result), who can be given the authority to remove and replace the trustee (whether or not the protector is acting as a fiduciary) if anything is suspected, demand an accounting from the trustee, and more. Other commentators suggest that the trust protector be expressly designated as acting in a non-fiduciary capacity (if state law permits, and if not creating situs and specifying governing law of a jurisdiction that does permit non-fiduciary capacity for the protector). Having a protector as a check and balance for the trustees or co-trustees can be helpful especially for a settlor facing health, cognitive or other challenges caused by aging, or otherwise. Also, consider assigning the revocable trust a separate tax identification number so that accounts are not under the client's Social Security number to make it more difficult for bad actors to identify the account.
- Involve family and others in developing a financial and legal safety net. For example, once financial accounts have been consolidated, have a consolidated statement sent to the client. This can make it easier for even a client with some degree of challenges to stay in control longer as one composite statement of all accounts with that institution can be far simpler to understand than a dozen or more different statements from different institutions. Then have a trusted family member, or if affordable, the client's independent CPA, receive duplicate copies of that statement for review. If a family member is named, consider naming a person who is not the agent under the client's power of attorney nor

[11] Advisers may also use online tools to monitor activity in vulnerable adult accounts. By way of example, consider the products and services available through the following link: www.eversafe.com.

the successor trustee of the revocable trust to receive statements so that there is some check on what the fiduciary might be doing.

- If appropriate to the plan, have consistency between all dispositive documents. The distributions under a will or revocable trust, if agreeable, can match the beneficiary designations under IRA, qualified plans and insurance policies, and so forth. That consistency may set a pattern that could be important later in the event of undue influence. The creation and retention of notes by the various members of the estate planning team regarding observations and statements of intent can prove vitally important in supporting the client's true intentions. Have the witnesses present during the review and explanation phase when instruments are being executed. Have the witnesses also record their observations in memorandum maintained with the clients file. Ask the client open ended questions about any changes that are being effectuated and their rationale for the changes being made. If there is any concern, you may wish to slow the process down, to see if in a subsequent meeting the desires and rationale for changes are expressed in the same fashion.
- Financial abuse of the elderly or infirm appears to be more rampant than statistics have identified. So many of these acts can be difficult or impossible to identify. Determining whether an elderly parent intended to give more money to a child who claims to have been a caregiver, or whether the purported caregiver was abusing the elderly parent, are difficult to differentiate. Taking proactive steps earlier on, with a collaborative team, looking at practical not just technical implications of planning, can provide more security. If a client wants to treat beneficiaries disparately, be sure to ask why and document the client's answer. If rationale for disparate treatment doesn't make sense, you may want to engage in a more in depth conversation with the client or even suggest an evaluation of the client's susceptibility to undue influence, when appropriate.

Use Temporary Exemptions Before the Disappear

No Clawback

Regulations were issued confirming that a taxpayer's use of the temporarily enhanced gift tax exemption will not result in a recapture or clawback when the exemption declines.[12] This Regulation begs the question for many clients "what are you waiting for?" With risks to the estate tax of the so-called Blue Wave continuing in 2020, and the proposal made by several of the Democratic presidential candidates (discussed later in more detail in this article), clients of even "moderate" wealth may benefit from transfers to reduce their estates now.

Perhaps, Only One (Not Both) Spouses Should Make Gifts?

Having one spouse make irrevocable transfers now may be critical to avoiding the so-called buyer's remorse that affected many 2012 last minute estate planning transactions. In many of those plans the transferor/donor made large wealth transfers in the rush of the December 31, 2012 anticipated deadline, and thereafter could not access those funds. While some clients might have regretted planning because the exemption did not decline to $1 million as feared, rather it

[12] Prop. Regs. 20.2010-1(c); Reg-106706-18.

may have been the lack of access to assets transferred that was the primary complaint. In the current trust planning environment, assuring access to assets can prove much more difficult than in the 2012 environment for two reasons. First, in 2012 any transfer of more than $1 million preserved exemption. In 2018, transfers might need to be quite substantial before any benefit of the temporary exemption is preserved. The reason is that, if (and when) the exemption drops to $5 million (adjusted for inflation) in 2026, the prior use of the exemption may not allow the new (lower) exemption to be used. For example, a client makes a taxable gift in 2019 of $5 million and dies in 2026 when the inflation adjusted exemption will be reduced to $5 million inflation adjusted. The taxpayer would have an estate (or gift) tax exemption of $1 million. In fact, this means that, if one wishes to use the part of the current exemption above $5 million (adjusted for inflation), he or she would have to make taxable gifts equal to the current enhanced exemption ($11.4 million for 2019) before the exemption is reduced.

Further, in 2012, most irrevocable trusts created to hold gifts and other transfers were structured as grantor trusts (that is, a trust where the income generated by assets of the trust is attributed under Section 671 to the grantor). A grantor trust could be structured to permit the spouse to have access. Also, the settlor could be permitted to borrow trust funds without adequate security. In the current 2018 planning environment, it may be advantageous to structure some trusts receiving gifts as non-grantor trusts (although the potential benefit of having more than one such trust may be curbed on account of the adoption of the multiple trust rule under Section 672(f)). This may require more complex planning to achieve goals that may be contradictory (as explained at greater length below). Practitioners may therefore consider having one spouse, not both, use the exemption thereby preserving more exemption.

> **Example**: Husband and wife have a combined estate of $16 million and are willing to make $8 million in transfers to irrevocable trusts to secure a portion of the temporary exemption. If each of husband and wife transfer $4 million to a non-reciprocal spousal lifetime access trust ("SLAT") in 2026 when the exemption declines by half, to perhaps $6 million, each spouse will be left with $2 million of exemption, or a total of $4 million. If instead husband alone transferred $8 million to a trust for wife and descendants, wife would still have her entire $6 million exemption left. For taxpayers with estates of a size where there is no need to preserve the new GST exemption, it might be prudent to make late allocations of GST exemptions to existing trusts so that if a future administration rolls back the 2017 Act's benefits, those trusts will already be exempt.

Variations of Domestic Asset Protection Trusts ("DAPTs") May Be Vital for Moderate Wealth Clients to Preserve Exemption

Modern trust planning techniques provide an array of options to permit a client to benefit from assets transferred to completed gift trusts that can use exemption. These include: DAPTs,[13]

[13] See: PLR 200944002. Self-settled trust jurisdictions now include: Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming. See: PLR 200944002. Under Section 6110(k), neither a private letter ruling (PLR) nor a national office technical advice memorandum may be cited or used as precedent, although they may prevent the imposition of certain tax penalties

hybrid-DAPTs where someone in a non-fiduciary capacity can name the settlor as a beneficiary, special powers of appointment to direct a trustee to make a distribution to the settlor,[14] variations of non-reciprocal SLATs, loan powers, floating spouse-clauses, etc. The number of states permitting self-settled trusts has grown steadily since Alaska enacted the first statute.[15]

A floating spouse clause provides that whoever shall be married to the settlor at any particular point in time shall be a beneficiary. So, if the client is married at the time an irrevocable trust is created, that spouse would be a beneficiary. If there is a later divorce that spouse would no longer be a beneficiary. If the client thereafter remarries, the new spouse would become a beneficiary. This could permit the client to indirectly benefit from the irrevocable trust through each successive spouse. If clients can have access to the assets transferred, there are fewer (if any) impediments to proceed with planning in light of the risks posed by a Sanders proposal, discussed below. Other than the cost of the planning, there may be less substantive downsides of planning now versus waiting and facing a potentially dramatically more limited planning regime. In fact, although effective estate tax planning always requires the client to give up access to assets[16], these strategies may nonetheless benefit him or her, as well as his or her family. The need to give up access in order to obtain tax savings may be something many moderate wealth clients have viewed quite differently with the current high exemptions; however, it might be appropriate to reexamine that perspective.

The need to use self-settled domestic asset protection trusts ("DAPTs"), or variations of DAPTs, to provide clients access to the large wealth that must be transferred to secure some portion, or all of the current large exemptions has increased post-2017 Act.[17] At the same time, there seems to be concern among some practitioners about the efficacy of this technique. Practitioners need to understand the issues to guide clients to make informed decisions about the use of DAPTs and variants, but to also give clients the comfort level to proceed with planning that could prove valuable (especially if the clients live in a DAPT friendly state).

Self-settled DAPTs may be more important post-Act. Access to assets to be transferred in order to use the temporary large exemptions may be critical for many clients other than certain UHNW (ultra-high net worth) clients. Many single clients, and even many married clients, will want or insist on being able to access the assets transferred. With historically high exemptions, very large transfers (relative to the net worth of moderate wealth clients - perhaps, defined as those having

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[14] O'Connor, Gans & Blattmachr, "SPATs: A Flexible Asset Protection Alternative to DAPTs," 46 Estate Planning 3 (Feb 2019). By definition, a SPAT is not a self-settled trust so that state statutes (e.g., NY EPTL 7-3.1) that permit creditors of the trust's settlor to access that assets in the trust and precedent (e.g., Rev Rul 2004-64, infra) which may cause such a trust to be included in the gross estate of the settlor should not apply.

[15] Self-settled trust jurisdictions now include: Alaska, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

[16] See, e.g., Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[17] For application of DAPTs to premarital planning, which has many similar concepts relevant to the discussion herein, see, Glazier, Shenkman and Gassman "DAPTs & Klabacka - At the Intersection of Estate Planning and Family Law," LISI Asset Protection Planning Newsletter #357 (February 1, 2018).

estates between $5 million to $40 million) are necessary to make a meaningful impact in securing the large temporary exemption.

When evaluating the possible use of a DAPT, practitioners should consider the *Wacker* case.[18] While some commentators have concluded that DAPTs are no longer viable post-*Wacke*r, most practitioners may believe that the *Wacker* case was a bad fact case that does not inhibit the use of DAPTs at all, although alternative approaches and structures to lessen possible risks appear to be more commonly used. Others view the *Wacker* case as quite limited and that it does nothing to change the risks of the use of DAPTs even by those residing in non-DAPT jurisdictions. Rather, they view *Wacker* as a limited case addressing jurisdiction, and another warning that no type of trust, self-settled or otherwise, can protect against a fraudulent conveyance.[19]

In *Wacker,* all the Supreme Court of Alaska held was that Alaska could not mandate that exclusive jurisdiction rest in Alaska where fraudulent conveyances to an Alaska DAPT were found to occur in another state. It did not invalidate self-settled trusts created in Alaska. Although courts in other jurisdictions entered a default judgment on fraudulent transfer allegations, the viability of Alaska self-settled trusts to shield trust assets from the claims of the grantor's creditors was not addressed.

The facts in *Wacker* included that after a Montana state court issued a series of judgments against Donald Tangwall and his family, the family members transferred two pieces of Montana real property to the "Toni 1 Trust," a trust allegedly created under Alaska law. That transfer was found to constitute a fraudulent conveyance.

Planning Post-*Wacker* and Post-Act might be somewhat different than under prior law. Even DAPT proponents seem to suggest a wide array of variants of the traditional DAPT technique to provide more security. A common-sense precaution includes taking proactive steps to corroborate that the trust and transfer to it are not fraudulent conveyances. These might include lien and judgement searches, other due diligence steps, having the transferor sign a solvency affidavit (whether or not state law requires it), forecasts by the client's wealth adviser demonstrating no anticipated need to access the DAPT assets, etc. Different requirements may be considered in light of larger percentage of wealth transfers for moderate wealth clients in order to use large temporary exemptions.

Additional considerations may include what life and long-term care coverage is in place pre-transfer? Should a large personal excess liability policy (umbrella) be acquired before a transfer? Should broader than traditional lien and judgement searches be obtained?

In a more recent case, a bankruptcy Judge found that a pre-existing asset protection trust, formed in the Cook Islands and moved to Belize, was subject to Florida law and not protected from the

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[18] *Toni 1 Trust v. Wacker*, 2018 WL 1125033 (Alaska, Mar. 2, 2018).

[19] Blattmachr, Blattmachr, Shenkman & Gassman on Toni 1 Trust v. Wacker - Reports of the Death of DAPTs for Non-DAPT Residents Is Exaggerated, Steve Leimberg's Asset Protection Planning Email Newsletter Archive Message #362, Mar. 18, 2018.

creditors of a Florida resident who was the settlor and beneficiary.[20] This case might raise concern that a non-DAPT state resident's creation of a DAPT in a DAPT jurisdiction may be tainted as governed by his or her home state laws. However, in *Rensin*, the facts of the debtor's circumstances were egregious. In another recent case, the Tax Court appears to have respected a foreign trust.[21]

One popular approach is referred to by some as a hybrid DAPTs in which the descendants of the settlor's grandparents can be added in as beneficiaries in the discretion of a person named to act in a non-fiduciary capacity. But when someone holds the power to add a beneficiary, the DAPT could be characterized as a grantor trust which may not be desirable in some instances post-2017 Act and a court may view that as evidence that the trust was self-settled to begin with. Practically, what this might mean, as noted above in other examples, is a combination of various trusts (grantor and non-grantor, as well as other characteristics) tailored to the particular client's situation. If a client is concerned that a democratic turn over in Washington could result in enactment of provisions similar to those proposed by Senator Sanders, the client might now consider creating or maintaining a grantor trust that might benefit from grandfathered treatment.

Another approach is to permit a person named in a non-fiduciary capacity to direct the trustee to make a distribution to the settlor. In this way, the trust is not self-settled which is the touchstone for attachment in many jurisdictions. If the power holder will not be an adverse party, the trust will be a grantor trust, under Sections 676 and 677.[22] If the trust is structured so as not to be a grantor trust, loan provisions may provide a means of access before turning on DAPT status. But if the loan may be made without the requirement of adequate security or adequate interest, grantor trust status will also ensue. Indeed, loans to the grantor from a trust, regardless of the terms of the loan, may cause the trust to be taxed as a grantor trust under Section 675(3). Another consideration may be to draft limitations into the governing instrument. For example, consider including a provision that no distributions can be made to the grantor for ten years and one day after transfers are made to the trust to address the rights of a bankruptcy trustee to disavow a self-settled trust under the Bankrupt Code.[23] Some practitioners provide that the Grantor cannot be added or appointed to be a beneficiary unless there is a divorce or death of a spouse.

If the trust is drafted as a third-party trust (that is, one not created by any beneficiary), and not a DAPT, but a power of appointment ("POA") is provided to a senior family member, that POA can be exercised in favor of an appointment to a trust that includes the original trust's settlor/grantor. That may not be characterized as a DAPT because the exercise of a POA probably will characterize the power holder, and not the initial settlor, as the transferor, especially if it is accomplished by use of a general power of appointment.

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[20] *In re Rensin*, 17-11834-EPK, 2019 WL 2004000 (Bankr. S.D. Fla. May 6, 2019).

[21] *Campbell v. Commr. of Internal Revenue*, 117 T.C.M. (CCH) 1018, 1 (Tax 2019).

[22] It may be feasible to create a non-grantor DAPT. Makransky v. Comm., 321 F.2d 598 (3rd Cir. 1963). See also, Lipkind, Shenkman and Blattmachr ["How ING Trusts Can Offset Adverse Effects of Tax Law: Part I," Trusts & Estates Sept. 2018, p. 26; "How ING Trusts Can Offset Adverse Effects of Tax Law: Part II," Trusts & Estates, Dec 2018, p.2.

23 Section 548(e).

The opinions of well-known practitioners vary across a wide spectrum. Some say from, on one extreme, DAPTs do not work so, therefore, they use only foreign asset protection trusts (“FAPTs”) to achieve these goals. On the other extreme, some practitioners believe that DAPTs do work and the dearth of significant cases that do not involve bad facts suggests that most DAPT challenges either do not succeed or settle favorably. Still other practitioners express considerable discomfort with using FAPTs and prefer variations of DAPTs. Even amongst DAPT naysayers, it seems that many agree that if the settlor is domiciled in a DAPT jurisdiction that the DAPT is more likely to succeed. Since the number of jurisdictions recognizing DAPTs has grown steadily, this creates more opportunities for use of this technique (even amongst practitioners who were historically leery of DAPTs).

If a primary goal of the DAPT is as a backstop to a prenuptial agreement would the risk/reward analysis be different?

Connecticut now allows asset protection trusts. Asset protection trusts have become an attractive way for grantors to retain the personal benefit of property transferred into an irrevocable trust, while still keeping the assets out of reach from future creditors. On July 12, 2019, the Governor of Connecticut signed into law the Connecticut Uniform Trust Act, which includes a Connecticut version of a qualified disposition statute. In 2019, Connecticut and Indiana joined the DAPT ranks.

Enhanced Note Sales to Grantor Trusts (“IDITs”) for UHNW Client Wealth Transfers

Many ultra-high net worth (“UHNW”) clients have pursued active estate tax minimization planning in the current environment. Some have given up on any hope of estate tax repeal and view the current environment (high exemptions, no Section 2704 Regulation restrictions on discounts, etc.), as the “best it will ever be” to plan. The 2017 Act has not by itself changed the techniques available to these UHNW clients. Nonetheless, practitioners would be well-advised to consider issues, concerns, and new ideas, which might be integrated into planning for these clients. With substantial wealth transfers being undertaken by this client segment, the differences in opinions about various planning techniques used by for clients consummating large wealth transfers are varied and fascinating to consider. These variations highlight the uncertainty of UHNW client planning, and perhaps provide opportunities to refine and improve planning techniques.

Create New Grantor Trusts to Freeze Estate Values and Enhance GST Benefits

UHNW taxpayers continue to proceed with planning as the Section 2704 Regulations have been withdrawn, the temporary increase in the exemption facilitates wealth transfers, and there is concern over what future law changes might do.

> **Example**: UHNW clients if they have, for example, large non-GST exempt trusts, might create new GST exempt trusts. A family member may create a new irrevocable trust that is a so-called Section 678 grantor trust as to the existing non-GST exempt trust, funding that new trust using a portion of her current enhanced gift and GST exemptions. If the old and the new trusts are both grantor trust, then the old non-GST exempt trust might

engage in transactions that attempt to shift value to the GST exempt trust, before the laws change unfavorably. One approach to this might be for the non-GST exempt trust to sell assets in a note sale transaction to the new GST exempt trust thereby freezing the value in the non-GST exempt trust.

This could be a useful planning tool but at present there is limited guidance.

Consider "Stepped" or Deferred Interest to Facilitate a Larger Sale than Current Cash Flow May Permit

Assume a client is going to engage in a note (that is, installment) sale to a grantor dynasty trust (which some call Intentionally Defective Irrevocable Grantor Trust or "IDIGT" although the result will be the same even if the trust is not intentionally made to be a grantor trust).[24] But what if the entity whose interests are being sold has current cash flow needs for business research and development? In such a situation, distributions might be difficult and/or limited for several years. Might the purchasing trust backload (defer) the interest that accrues under the term of the note? If this were done during the first X years of the note, the purchaser might pay interest every year at a rate of say 1%. The remaining and unpaid 2% interest (assuming a 3% AFR) will compound at the same 3% AFR rate until it is paid. Thus, the note will have negative amortization during the first X years of its term. After the first X years, the purchasing trust would then pay the full interest that accrues every year on a current basis (or if advisable from a cash flow perspective another "step" in rate could be used). During the remaining term of the note, the purchaser will also pay the compounded shortfalls in interest payments that arose during the first X years of the note.

If the purchasing trust will not have sufficient cash flow to currently pay all the interest that would have normally accrued during the first X years of the note, it might be argued that the purchasing trust could be characterized as "thinly capitalized." Therefore, practitioners considering such a note structure should confirm and corroborate that thin capitalization is not an issue as that might undermine the validity of the debt itself and hence the transaction. It may be important to avoid transactions that might create an issue as to whether the note will be respected as debt or whether it could instead be characterized as equity. The issue of the trust not being "thinly capitalized" will generally depend on the balance sheet of the trust at the time of the transaction reflecting the then current appraised value of assets owned by the purchasing trust.

The delayed payment during the first X years of the note of the interest that accrues generally should not by itself cause the note that the purchaser gives to the seller to be re-characterized (e.g. as an invalid indebtedness, a gift, as equity instead of debt, etc.).

Using variable interest should not by itself undermine the validity of a note. If a loan requires payments of interest calculated at a rate of interest based in whole or in part on an objective index or combination of indices of market interest rates (e.g., a prime rate, the applicable federal rate, the average yield on government securities as reflected in the weekly Treasury bill rate, the Treasury constant maturity series, or LIBOR (London interbank offered rate)), the loan will be

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[24] Portions based on: Shenkman and Blattmachr: "Estate Planning Updates and Planning Nuggets January - April 2019," Estate Planning Newsletter #2728 (June 4, 2019).

treated as having sufficient stated interest if the rate fixed by the index is no lower than the applicable federal rate (1) on the date the loan is made, in the case of a term loan, and (2) for each semiannual period that the loan is outstanding, in the case of a demand loan.

For term loans, determining the appropriate AFR is simply the use of an interest rate that is equal to the AFR with the same compounding period for the month in which the loan is made. For sale transactions the appropriate AFR is based not on the term of the note, but on its weighted average maturity.

Section 7872, which created new rules for the tax treatment of loans with below-market interest rates, went into effect on June 6, 1984. The scope of this code section and its application for gift tax purposes were addressed in *Frazee*.[25] The Tax Court determined that the Section 7872 applicable federal rate ("AFR"), and not the Section 483(e) 6% interest rate, was controlling for gift tax valuation purposes. Accordingly, because the intra-family sale of real property in *Frazee* was not a bona fide arm's-length transaction free of donative intent, the court held that the excess of the face amount of a note bearing 7% interest over its recomputed present value, using the applicable federal rate for long-term loans, constituted a gift of interest.

Section 7872 applies to any transaction that (1) is a bona fide loan, (2) is below market, (3) falls within one of four categories of below-market loans, and (4) does not qualify for one of several exceptions. The four categories are loans (1) from a donor to a donee, (2) from an employer to an employee, (3) from a corporation to a shareholder, and (4) with interest arrangements made for tax avoidance purposes.[26] The below-market-rate demand loan is a two-step transaction:

- The lender is treated as having transferred on the last day of the calendar year an amount equal to the forgone interest (the prevailing federal rate of interest less the loan's actual interest rate) to the borrower; and
- The borrower/trust is then treated as transferring that amount back to the lender as imputed interest.

What if the loan provides adequate interest so that it is not a below-market loan? There is no forgone interest to report under Section 7872. But if the note provides for the interest to accrue and is not paid, the original issue discount (OID) rules will apply. The OID rules do not apply merely because interest that is to be paid currently is not paid. They only apply where there is accrual/deferral by the terms of the note. The OID rules would have the taxpayer report a pro rata amount of the overall mount of the OID over the life of the loan using a constant yield method under the Regulations for Section 1272. But on a sale to a grantor trust the OID complications appear to be obviated at least until grantor trust status terminates. So, while these rules should apply, they should have no income tax significance.

Different variations can be devised based upon the needs of the parties. Consider:

- Interest may be accrued rather than paid during the term of note.
- Pay interest that cannot be paid in cash by issuing a note from the borrower/trust for any unpaid interest. There does not seem to be any consistency in views as to whether this

[25] *Frazee v. Commissioner*, 98 Tax Ct. 554 (1992).

[26] Section 7872(c); Section 7872(a)(1).

will make the note more problematic to support on audit. One view is that there is nothing prohibiting paying a note interest payment in-kind, e.g. with another note. The opposing view is that this might make the transaction appear uneconomic in contrast to "baking in" the cash flow considerations from inception, e.g. with a stepped note.

Be Wary of the Hart Scott Rodino Act Requirements

Practitioners should be mindful that large estate planning transactions may trigger reporting requirements under Hart-Scott-Rodino Antitrust Improvements Act ("HSR").[27] HSR imposes an obligation to file a premerger notification report form with the Premerger Notification Office of the Federal Trade Commission ("FTC"). This may all be counter-intuitive since a sale of interests in a closely held or family business to a trust created by the family can hardly be viewed as negatively impacting competition, but meeting the filing requirements, or finding an exemption, is necessary to avoid potentially onerous penalty provisions.

Acquisitions resulting from a gift, intestate succession, testamentary disposition or transfer by a settlor to an irrevocable trust may be exempt from the filing or other requirements of HSR.[28] However, the conclusion may not be simple or assured and practitioners should consider consulting with an expert in these matters. There could be an impact on the HSR determination based on trustee and trust protector provisions included in the trust instrument, and, specifically, who has the ability to remove and replace trustees.

A settlor's retention of the ability to remove and replace the trustee, or the right of a trust protector to do so, of an irrevocable trust might cause the trust's voting securities to be treated as part of the settlor's ownership share of an entity for purposes of HSR testing.

If the trust protector of a trust has the contractual power to remove and replace 50% or more of the trustees, the protector may be considered a control person. Pursuant to informal conversations with the FTC staff, that power of the trust protector must be absolute and not, for example, merely the power to name a successor trustee without the power to remove, and would not include instances where the power to remove and replace is subject to consent of a third party. Additionally, in testing HSR filing requirements, holdings of spouses are considered to be the holdings of each them.[29]

The company is its own Ultimate Parent Entity ("UPE") in that no other entity "controls" it; after the acquisition, the protector might be viewed as in "control" of the entity by virtue of holding 50% or more of its voting securities. In addition to "voting" control, there is an alternative control test for corporations having the contractual power presently to designate 50% or more of the directors. Inquiry might be appropriate as to whether an investment advisor (investment trustee) in a directed trust, who can vote the equity interests, might also be classified as a UPE

[27] See Jay D. Waxenberg and Jason A. Lederman, "The intersection of trusts and anti-trust: Why you, an estate planner, should care about Hart-Scott-Rodino," 51 Real Property, Trust and Estate Law Journal, at 431.
[28] 16 CFR Part 802.71.
[29] 16 CFR Part 801.1(c)(2).

based on the above. However, this nonetheless may not affect the HSR analysis as to whether an exemption applies.[30]

If the exemption does not apply and filing is required, the protector or, perhaps, investment trustee may be considered the "acquiring person" and the company (since it is currently its own UPE) would be the "acquired person". Should that occur then, perhaps, both the trust protector and the company could be required to file. There would be one filing fee which would be based on the value of voting securities of the company that the protector would "hold" as a result of the acquisition (both what is currently held and what is being acquired). The filing fee would be based on the size of the transactions.

An informal opinion might be obtained from the FTC as to whether a proposed transaction, e.g. a note sale transaction to a grantor trust is exempt even though the transfer would meet the HSR size of transaction and size of person tests.[31]

The FTC may not dispute the proposition that essentially internal, estate-planning-driven transfers of family businesses to a trust should be exempt, while acquisitions by a trust from third parties should not.

There is no reason why government should be concerned about a family transaction as this has nothing to do with significant businesses combining. The regulators may respond that they do not think that trust protector status is significant. Nonetheless, any time a large transaction is contemplated, a mergers and acquisition specialist should be involved to parse through the HSR exceptions to confirm no filing needed.

Differentiate Collateral on Note Sale to Possibly Break IRS Challenges of a Retained Interest on a Note Sale

When selling assets to an existing irrevocable trust that has already benefited from prior planning, another planning option might be to consider using assets other than the assets being sold in the current transaction as collateral.

> **Example**: ABC, LLC interests were sold to a trust years ago and that transaction has been completed and any note repaid. Now, the taxpayer is contemplating selling XYZ, LLC interests to the same trust. Instead of using XYZ, LLC interests as collateral on the note the trust gives the selling taxpayer, what if instead ABC, LLC interests are used as collateral for the note? Might that reduce the potential strings attached to the asset sold that the IRS might use to argue for estate tax inclusion?

What if a guarantee is used and the terms require that the seller/lender/donor must first proceed against the guarantor before proceeding against the collateral? While unconventional, might that create more distance from the asset sold if there is no collateral in the trust other than the original asset? How would the guarantee fee have to be adjusted to reflect this increased risk? Since the guarantor would be first "in line" before the collateral, the fee to be charged would have to be

[30] 16 CFR Part 802.71.
[31] 16 CFR Part 802.71.

greater than in a traditional guarantee arrangement. In such instances, it might be prudent to have an independent appraiser evaluate what a fair guarantee fee might be for the transaction.

Defined Value Mechanisms Might be Enhanced and Modified for New Planning

Can the potential gift tax risk of a large transaction be minimized? While large transactions often include mechanisms to minimize current gift tax risk, there seems to be some disagreement in the planning community about how to structure such arrangements than might be expected. For UHNW clients pursing current large dollar planning, using some variation of these mechanism may warrant consideration. Some transactions are structured using some application of one of the key defined value cases.[32] These types of mechanisms are based on the entirety of the intended value being transferred away from the transferor. However, if there is an excess value over what the buyer in the transaction is paying, as a result of an IRS audit adjustment, that excess value is poured into a non-taxable receptacle. This non-taxable receptacle could be a charity (but, be cautious if a private foundation is used since this may not be a feasible mechanism), a grantor retained annuity trust ("GRAT"), marital trust (other than a "QTIP" which requires the election to be made on the gift tax return by the due date for the year the gift was deemed to have been made), or an incomplete gift trust. However, as with many aspects of planning, there is little agreement amongst practitioners as to which spillover or structure is best. Practitioners need to weigh the options when evaluating UHNW transfer planning. While the law is not new in this area, there are new perspectives and planning structures that the following discussions endeavor to present. A complete discussion of already established law will not be provided.

Is *Wandry*[33] King? What Type of Price Adjustment Mechanism Might You Use?

The *King* case might provide a planning option to consider.[34] *King* upheld the use of a price adjustment clause.

> **Example**: Simplifying, this might be as follows: "Taxpayer hereby transfers $100 worth of stock to XYZ trust for a note. If the value of the stock is finally determined for gift tax purposes to be greater than $100 the face amount of the note shall be adjusted accordingly." Some practitioners report what they described as favorable results on audits using this approach.

Other practitioners are less optimistic and are simply not comfortable with a *King* type approach. Some object to *King* based on the structure of the adjustment. For example, might the adjustment of the note be viewed as an impermissible condition subsequent under a *Procter*[35] analysis? On the other hand, some view *King* as an "outlier" not to be relied upon because it is only a 10th

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[32] *McCord*, CA-5, 2006-2 USTC ¶60,530; *Petter Est.*, 98 TCM 534, TC Memo. 2009-280; *Christiansen Est*., 130 TC 1, CCH Dec. 57,301, aff'd CA-8, 2009-2 USTC ¶60,585

[33] *Wandry, et al. v. Comm'r*, TC Memo 2012-88.

[34] *J. King*, CA-10, 76-2 USTC ¶13,165.

[35] *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944).

Circuit case. The *Ward* case rained a bit on the *King* parade according to some views.[36] A variation of a traditional *King* type approach might be for the note's face value to be defined as being the gift tax value as finally determined.[37] Does this negate a challenge under *Procter*? In any case, the federal district court distinguished *King* from *Procter* because the court found that the sale transaction was made in the ordinary course of business, at arm's length and free from any donative intent, which under Reg. 25.2512-8 meant there was no gift. That may be a difficult standard to sustain in some transactions.

Wandry might present another option to consider as part of the efforts to minimize gift tax.[38] In the *Wandry* case, the tax court upheld an approach that relied on the transfer of a fixed value of assets to a trust rather than a specified portion of equity.

> **<u>Example</u>**: Simplifying, this might be as follows: "Taxpayer hereby transfers $100 worth of stock to XYZ trust." While many practitioners prefer a *Wandry* approach over a *King* approach, the IRS has non-acquiesced to the *Wandry* decision.[39] Thus, in a "traditional" *Wandry* clause the taxpayer may transfer a fixed dollar amount of shares only (that is, "I hereby transfer $100 worth of stock in XYZ"). Another variation of a *Wandry* approach is for the beneficiaries to execute a disclaimer of any value in excess of the specified value. The concept behind this approach is that this would make it difficult for the IRS to argue more was transferred if the recipient trust is prohibited by the disclaimer from accepting the incremental value.[40]

Consider a Two-Tiered *Wandry* Approach to Deflect a *Powell* Challenge

There are certain circumstances when a client may need to transfer all of the equity in a closely held business. By way of example, the transferor may have an income tax or contractual reason to transfer all equity. On these occasions, it may not be feasible to use a traditional *Wandry* clause that could result in some part of the equity being returned to the transferor.

There may be income tax or contractual reasons transferring all the equity. One problem with a *Wandry* clause is that it could leave shares in the selling taxpayer or trust's hands, which may not be desirable for business or personal reasons. This could create uncertainty with respect to the trust's ESBT status if all S corporation shares are sold but the operation of a *Wandry* clause causes share to remain in the trust. For example, does the ESBT election end when all shares are sold? If so what occurs when it is later determined that S corporation shares are held in the selling trust?

The solution, in some circumstances, may be a "two-tiered *Wandry*" arrangement which consists of a traditional *Wandry* transfer followed by the simultaneous sale of any shares (or other assets)

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[36] *C. Ward*, 87 TC 78, CCH Dec. 43,178.
[37] This idea is attributed to Steven Gorin, Esq., Gorin, part III.B.3.a.iv. Defined Consideration Clause, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications" (printed 7/14/2019), available by emailing the author at sgorin@thompsoncoburn.com.
[38] *Wandry et al.*, 103 TCM 1472, CCH Dec. 59,000(M), TC Memo. 2012-88.
[39] IRB 2012-46.
[40] This idea is attributed to Stacy Eastland.

left by the *Wandry* adjustment clause if the clause is triggered. In other words, the transferor makes a gift of a specified value of the shares of the entity, believing that all of the transferor's interest in the entity is equal to the value being transferred. In the event that the shares are re-valued on audit (such that the value that the transferor sought to transfer does not cover all of the shares), the transferor will have sold shares that exceed the intended gift value. The second tier of the *Wandry* arrangement could consist of a second sale of any shares, effective as of the same date as the primary *Wandry* sale, that remain by operation of the *Wandry* arrangement in the selling taxpayer or trust's hands. The price for this second sale, if any, would be for a price equal to the gift tax value as finally determined. The sale would be supported by a note upon which interest accrues from closing and is required to be made current within a specified time period, e.g., 90-days of the final determination.

It might be better, if feasible, for a transferor to use grantor trusts for these types of arrangements. Otherwise, if the *Wandry* clause is triggered, the transferor could incur an income tax – and possibly interest and penalties – for a sale transaction deemed to have occurred on the date when the original gift was made. However, in some instances, if shares are held by a non-grantor trust there may be no viable option for avoiding income tax on the transaction (e.g. a non-grantor trust that is not GST exempt is the transferor).

Further, to the extent that the asset being sold consists of S corporation shares, a non-grantor trust may not be a valid shareholder (baring an ESBT or QSST election), which could potentially challenge the entity's status as an S corporation.

> **<u>Example</u>**: On March 1, 2019, Jack transfers all of his shares in his S corporation with an aggregate fair market value of $1 million to the Jack Family Trust, which is a valid S corporation shareholder (it is either an ESBT, QSST, or grantor trust). Jack believes that he has transferred all of his S corporation shares but, if it turns out that the aggregate value of all of Jack's shares were worth more than $1 million, Jack will be deemed to have sold the excess shares to the Jack and Jill Trust, which is a non-grantor trust. The Jack and Jill trust does not own any S corporation shares. In 2022, the IRS picks up Jack's gift tax return for audit and determines that the value of the shares transferred to the Jack Family Trust was $1.2 million. As a result, Jack is deemed to have sold $200,000 worth of shares of S corporation stock to the Jack and Jill Trust on March 1, 2019. However, the time for the Jack and Jill trust to make an ESBT election or otherwise qualify as a valid S corporation shareholder has long since passed. As a result, the entity itself could be deemed to have lost its S corporation status.

Incorporate an Economic Adjustments Mechanism in Your Defined Value Technique

Inherent in many defined value mechanisms is that an adjustment might be made at a future date and affect which taxpayer owns the particular assets (e.g., stock in a closely held business or an LLC interest) from the inception of the transaction. While defined value mechanisms routinely address the allocation of these equity interests, how are the economic implications of the adjustment provided for? If five years pass from the date of a transaction until the interests sold are determined definitively, how will the economic consequences of that five-year period addressed? The consequences might include dividends or distributions that need to be repaid from the recipient to the correct party, e.g., the seller. Also, what mechanism will be used to assure that the equity interests are properly adjusted? Will merely providing for an adjustment clause alone suffice? Consider the following possible approach illustrating provisions when the valuation adjustment mechanism uses a spill-over of excess value to a grantor retained annuity trust ("GRAT").[41]

> **Sample Economic Adjustment Clause Between Buying Trust and GRAT:** A re-allocation of funds may be required as a result of any re-allocation of the Shares from the Buyer to the GRAT under the economic adjustment provisions of the Transfer Agreement following an initial adjustment (e.g., an income tax audit). A second re-allocation of funds may be required as a result of a second adjustment to the allocation of the Shares from the Buyer to the GRAT following a second and final adjustment (e.g., a gift tax audit following an initial income tax audit). It is understood that the Escrow Agent shall not release any of the Shares to the Buyer or the GRAT until the Buyer and the GRAT: (i) acknowledge in a written document acceptable to the Escrow Agent (the "Escrow Release") that pursuant to the terms of the Transfer Agreement, the Buyer and the GRAT have determined the number of Shares to be sold to the Buyer (i.e., the Actual Sale Shares) and the number of Shares to be gifted to the GRAT (i.e., the Actual Gift Shares") and (ii) set forth in such Escrow Release instructions directing the Escrow Agent as to the number of Shares that are to be released to each Party…. It is understood that the CPA Report will corroborate the amount of dividends, other distributions, or other economic benefits that accrued to the Buyer prior to the Distribution Date (as defined in the Transfer Agreement), and that are properly allocable to the GRAT, if any. The Escrow Agent shall not submit the Existing Stock Certificate, the Sale Stock Power or the Gift Stock Power to the Corporation (or its transfer agent) pursuant to Section X until after the Escrow Agent receives written notice signed by the Buyer and the GRAT, in form and substance satisfactory to the Escrow Agent, that the Buyer has reimbursed the GRAT, or made adequate arrangements to reimburse the GRAT as permitted under the Transfer Agreement, for any amounts payable to the GRAT pursuant to the CPA Report."

Consider Using a Two Tier Defined Value Adjustment on Sales to Non-Grantor Trusts

The use of non-grantor trusts may have application beyond planning post-Act to garner income tax benefits. A sale to a grantor trust would be essential if there is significant gain in the assets being sold in order to avoid recognition of gain. Also, use of a grantor trust provides continued tax burn, and the ability to exercise a swap or substitution power which could be indispensable to basis step-up planning (by trading high basis assets the grantor owns for low basis assets in the trust, before the grantor dies). But in some instances, use of a non-grantor trust might be advantageous as the buyer in a note sale or other transaction, even if unusual. The basis step-up on the death of the first spouse's might permit avoiding capital gain on a sale. Also, an old no-longer grantor trust may have substantial assets and avoid the need for seed gifts or guarantees and make the perceived risk of the transaction lower.

How should a defined value mechanism be structured for such a transaction? It would appear that a two-tier defined value mechanism would be necessary to address both income tax audit

[41] Reg. 25.2702-3.

results as well as gift tax audit results, since a sale to a non-grantor trust could trigger both income and gift tax audit adjustments. The income tax audit adjustment could be based on an IRS argument that the value of the asset (e.g., stock in a closely held corporation) was understated so that the transaction is in reality a part gift/part sale with less shares having been sold. This adjustment could be independent from a later gift tax audit that argues that the valuation was low, and hence a gift made. Thus, in contrast to the economic adjustment clause illustrated above for a sale to a grantor trust, a two-tier adjustment might be necessary to conform the economics to the ultimate result of the transaction.

> **Sample Clause**: "The Parties acknowledge that a second economic adjustment may be required if there is a second tax adjustment (e.g., a gift tax audit following an earlier income tax audit at which time an adjustment was made). Should this occur, the Parties further agree to take any and all reasonable additional actions, and to execute any additional documents, in order to effectuate such adjustment payments, as the Accountant determines appropriate, if any."

An escrow agreement governing the holding of transfer documents might then address both the income and gift tax audit which would impact the release of equity as well as the holding of equity as security for the note.

> **Sample Clause**: "Allocation of the Shares. The Shares shall be held by the Escrow Agent pending the events necessary for the Shares to be valued, which may occur in two tranches, resulting from an income tax audit and a gift tax audit. As a result of that valuation process, the Parties shall determine, pursuant to the Transfer Agreement, the number of Shares that shall be deemed sold to the Buyer effective as of the date hereof (the "Actual Sale Shares") and the number of Shares that shall be deemed gifted to the GRAT (the "Actual Gift Shares")…All of the aforementioned steps are independent of the events associated with the repayment of the Secured Promissory Note (as defined herein)."

Since the buyer is a non-grantor trust it may have incurred income tax as a result of distributions, dividends or other economic consequences while holding business interests it purchased pending a final determination of the gift tax value and the adjustment to reflect that result. Does this tax cost get factored into the economic adjustment clause concept discussed above?

Divide a QTIP to Possibly Contain the Risk of a 2519 Challenge

The transfer of the qualifying income interest of the spouse is a transfer by the spouse subject to gift tax under Section 2511.[42] If the IRS were to successfully assert a Section 2519 transfer (because the spouse lost part of the income interest in the trust), the entirety of a QTIP trust would be deemed transferred with potentially significant gift tax consequences for UHNW clients (for lesser wealth clients the current high exemptions might eliminate any tax cost to a 2519 challenge and hence make this otherwise worrisome tax challenge an affirmative planning tool).[43]

[42] Section 25.2519-1(a).

[43] *Estate of Kite v. Commr.*, T.C. Memo. 2013-43, Feb. 7, 2013.

Given the draconian consequences a successful Section 2519 challenge could have to a client transaction suggest that if steps can be taken to insulate or minimize that risk, or in some instances alternate planning structures used, it might be advantageous, although it may be difficult to evaluate the scope of that risk or to weigh the effectiveness of the steps that might be taken. If a sale is to be made by a trust that is part of a QTIP trust, perhaps steps can be taken to insulate the remainder, or main QTIP trust. A 2014 PLR provides a suggestion as to how, in part, this Section 2519 insurance can be obtained. [44] The concepts in the PLR might be extended further to provide insulation to different types of estate planning transactions.

The PLR provided as follows:

> "Decedent's executor elected to treat Marital Trust as qualified terminable interest property (QTIP) under § 2056(b)(7) of the Internal Revenue Code...The trustees of Marital Trust propose to divide Marital Trust into three separate trusts, Trust 1, Trust 2, and Trust 3. The terms of Trust 1 will be identical to the terms of Marital Trust. Following the division, the trustees intend to convert Trust 2 to a total return unitrust with an annual unitrust payment equal to not less than three percent or more than five percent of the fair market value of the assets of Trust 2 determined as of the first day of each taxable year. The trustees, with the consent and joinder of the trustees of Family Trust and Decedent's children, will petition Court for a court order to terminate Trust 3 and distribute the assets of Trust 3 equally to Decedent's children…the division of Marital Trust into three separate trusts each separate trust will be a QTIP trust under § 2056(b)(7) and the division will not be a deemed gift or other disposition under § 2519."

But the division of marital trust might be used more proactively to insulate against a Section 2519 attack if the QTIP trust is selling an asset. Assume, for example, that an irrevocable trust that qualifies as a QTIP trust (e.g. a failed GRAT structured to qualify for a marital deduction) is, pursuant to the terms of the governing instrument, to be combined or poured into the primary QTIP trust. If that first trust is to engage in a sale or transaction that might pose any 2519 arguments, perhaps the two QTIPs can be bifurcated to prevent a 2519 attack from reaching the second QTIP. In other words, one might wish to take steps to prevent the otherwise intended combination of the two QTIP trusts (e.g. the failed GRAT/QTIP merging into the primary QTIP at the end of the term of that failed GRAT). The same governing instrument might include powers to divide trusts and even not to merge trusts. Consider the following language:

> "Whenever two trusts created under this instrument are directed to be combined into a single trust (for example, because property of one trust is to be added to the other trust). The Trustee is authorized, in the exercise of their sole and absolute discretion, instead of combining said trusts, to administer them as two separate trusts with identical terms in accordance with the provisions that would have governed the combined trusts."

[44] See PLR 201426016.

It may be feasible for the trustees of each of the QTIP trusts to exercise these powers in advance to prevent merger and to otherwise administer the trusts as independent and separate QTIP trusts. If an institutional trustee is named in any of the QTIP trusts it may be feasible for the institution to confirm the action to prevent a merger of the separate QTIP trusts to provide greater independence to the transaction then if merely family members approved the transaction. This affirmative action prior to consummating a transaction could make it difficult for the IRS to assert a Section 2519 challenge against the QTIP trust that did not engage in the subject transaction.

Use of an Independent Escrow Agent

If a sale occurs subject to a defined value mechanism and/or a deferred payout supporting the note, who holds the collateral for the note? Who holds what documentation pending the resolution of the defined value mechanism? In most cases these documents are held by the estate planner crafting the transaction. Might there be a better option? The *Ward* court noted:

> "Furthermore, since there is no assurance that the petitioners will either recover the excess shares or, at the time of their deaths, possess the power to recover such shares, and since the shares are not worthless, the petitioners' estates may be reduced by the transfer of the shares."[45]

Might having title documents held in the hands of an independent escrow agent who assures that necessary adjustments are made, deflect this concern? Using an independent law firm, not a firm otherwise involved in the transaction, with a detailed escrow agreement specifying which documents should be held, and how they should be handled, might add additional credibility to the arrangement and negate the issue raised by the *Ward* court. Endeavoring to adhere to all relevant formalities could be important.

In the *Wandry* case the taxpayers listed percentage interests on the schedules attached to the gift tax return, not dollar figures as would have been consistent with the transfer of a fixed dollar amount. While the court did not change its conclusion because of this issue, it is certainly better to avoid such inconsistencies. Adhering to the formalities of a detailed escrow agreement, one reviewed along with all documentation by an independent agent, might also help safeguard transactions from these issues.

Use Non-Grantor Trusts for Planning Benefits

Use Non-Grantor Trust for Asset Protection Planning for Moderate Wealth Physician Clients

Asset protection considerations of non-grantor trusts deserve additional attention post-2017 Act. With moderate wealth clients not facing any federal estate tax, unless they are domiciled in a decoupled state that could result in a state estate tax, there may be no transfer tax benefit to

[45] The Ward Court referenced See *Harwood v. Comm'r.*, 82 T.C. at 275 n. 28. *Ward v. Comm'r.*, 87 T.C. 78 (1986); Rev. Rul. 86-41, 1986-1 C.B. 300. Cf. *King v. U.S.*, 545 F.2d 700 (10th Cir. 1976).

creating a grantor trust plan that affords asset protection, e.g. a DAPT or non-reciprocal SLATs for married couples. It may only be the income tax benefits afforded by a plan based on non-grantor trusts that offers a non-asset protective rationalization for the planning.

> **Example**: Physician and her spouse have a net worth of $12 million. Prior to the Act the couple faced a federal estate tax. Shifting assets to non-reciprocal spousal lifetime access trusts ("SLATs") would likely save estate tax, and that tax savings would likely grow as the estate grew. However, post-2017 Act the same couple would realize no estate tax benefit from creating non-reciprocal SLATs. Perhaps, there are insufficient other non-asset protection justifications for the plan other than asset protection. However, if a non-grantor trust were instead created, and state income tax, SALT and other income tax savings are realized, those income tax savings might lend support to the non-assets protection motives for the trust.

Create a Non-Grantor Trust for Charitable Contribution Deductions for Moderate Income Client

Considerations in charitable planning have changed as a result of the 2017 the Act in several ways. One potentially significant transformation will be an increased use of non-grantor trusts. Most taxpayers will not exceed the new standard deduction threshold thereby losing the tax benefits of charitable giving. It is estimated that the doubling of the standard deduction to $24,000 for a married couple has lowered charitable giving by individuals $13 billion+ per year[46]. Some commentators have suggested that the overall impact on charitable giving may not be significant. However, it may be difficult to quantify the negative impact on tax reform versus the positive impact on giving resulting from the growth in the stock market and job data.

The doubling of the estate tax exemption to more than $11 million has been estimated to lower charitable giving by $4 billion per year.[47] Creative tax planning, and emphasizing non-tax benefits, may help offset some of this loss. Apropos to this article, will be the use of non-grantor trusts to salvage much or all this deduction. While the media has focused on bunching itemized deductions and using donor advised funds ("DAFs") to circumvent the impact of the doubled standard deduction, that may not be feasible for many taxpayers. With the significant restrictions or elimination of so many itemized deductions, bunching (even using a DAF to bunch charity) may not push a taxpayer over the new standard deduction threshold. Even if the exemption threshold can be exceeded every 2nd or 3rd year of bunching, the donations made up to that level in any given year will still be lost.

> **Example**: Client has $10,000 of SALT deductions and donates $5,000/year to charity. If they bunch donations to every third year they will have a $25,000 deduction in that year ($10,000 SALT + 3 x $5,000). But that would only provide a net incremental deduction of $1,000. While no doubt some taxpayers will benefit from bunching, the utility seems overstated for many.

[46] https://beta.washingtonpost.com/business/2019/02/26/definitely-bad-news-new-study-finds-charitable-giving-grew-sluggish-last-year/?noredirect=on .

[47] https://www.councilofnonprofits.org/sites/default/files/documents/tax-bill-summary-chart.pdf .

It is anticipated that the number of itemizers will plummet. One estimate predicted that the number of taxpayers who itemized would decline from 46.5 million in 2017 to only 18 million in 2018.[48]

For both lower and moderate wealth taxpayers, emphasizing non-tax benefits of using IRA funds for those over 70 ½ and donating appreciate assets (and avoiding tax on the appreciation), are still beneficial charitable planning strategies.

For moderate wealth clients, creating a simple local non-grantor trust with a non-compensated family member trustee, may serve to salvage charitable contribution deductions. When drafting these trusts practitioners should include language in the instrument that directs that distributions to charity be made from gross income.[49] These moderate wealth taxpayers can then gift enough investment assets to generate sufficient income to pay intended contributions. The trust instrument can name heirs as well as charities as beneficiaries and grant the trustee a flexible distribution power to allocate among charitable and non-charitable beneficiaries. This approach will facilitate moderate wealth taxpayers donating to charities and securing the equivalent of a full income tax deduction, or when they desire instead having heirs in a given year receive some portion or all the income, so that there is flexibility to the planning, even with using an irrevocable trust as the vehicle. For UHNW taxpayers more robust and complex non-grantor trusts achieving a range of goals may be used to also fund charitable gifts along similar lines. However, many UHNW clients already give donations that are substantially more than the standard deduction, for those clients use of these techniques may not result in a significantly different charitable deduction. Nonetheless, the use of charitable remainder trusts may remain a valuable tool, not only for UHNW clients, but also persons of lower net worth, should the SECURE Act pass the Senate and result in a significant shortening of stretch IRA payout provisions.

Create a Non-Grantor Trust in a Trust Friendly State to Save State Income Taxes

State income taxation on non-source, e.g. passive assets, may be deferred or avoided through the use of non-grantor trusts. This type of planning may be more common for two reasons. First, the SALT limitations make the net cost of state income taxes much higher than before the Act. Therefore, many taxpayers, especially those in high tax states, may wish to pursue this type of planning. Further, given the number of other tax savings opportunities from using non-grantor trusts, taxpayers may already be creating non-grantor trusts for other purposes after the Act.

Practitioners should evaluate whether existing trusts paying high state income tax can be modified or moved so that the state income tax may be avoided. An existing trust may be able to be moved to a new state that has a more favorable tax system. That may require moving assets out of the initial state, changing trustees to out-of-state trustees, and assuring no initial state source income. If source income cannot be avoided it may be feasible to divide the existing trust using powers in the instrument, decanting or non-judicial modification, so that one resulting trust

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[48] Erica York, "Nearly 90 Percent of Taxpayers Are Projected to Take the TCJA's Expanded Standard Deduction," https://taxfoundation.org/90-percent-taxpayers-projected-tcja-expanded-standard-deduction/ , September 26, 2018

[49] Section 642(c).

has solely non-source income and the other resulting trust earns all source income. Only the former trust would be moved. This type of planning can raise complex issues. What is source income? If the trust owns a partnership interest that has a modest amount of source income in the initial state, might suffice to taint the entirety of the trust as source income.

In moving trustees out of state what of an investment advisor or trust protector in the initial jurisdiction? Will that taint the trust as still being subject to taxation in the initial state? Will it suffice to create a limited liability company ("LLC") or other entity in the new jurisdiction, in order to house the protector, investment adviser and other positions, so that it is that entity and not the individual resident is in the initial state break the tie to the initial jurisdiction?

Practitioners and trustees might consider reviewing the possible benefits of converting a grantor trust to a non-grantor trust to save state income taxes. Caution is important. What if the Bernie Sanders-type estate tax proposal of including grantor trusts in the grantor's estate is eventually enacted?[50] It might be wise to retain a grandfathered grantor trust (if that is feasible). Also consider) even if that means sacrificing the current income tax benefits of having a non-grantor trust. Also, consider the implications of installment sales, negative basis, and income tax consequences on conversion. Evaluate whether grantor trust status versus possible state income tax savings is preferable.

A new non-grantor trusts might be created by transferring passive assets, e.g. portfolio assets, to a non-grantor trust in a trust friendly jurisdiction that would not impose any state income tax. An existing grantor trust might be retained as mentioned above.

Use Non-Grantor Trusts to Save Net Investment Income Tax ("NIIT")

It may be feasible to use non-grantor trusts to save net investment income tax ("NIIT").[51] If the trustee is actively involved in the business held in a non-grantor trust, the NIIT tax may not apply whereas had the client held that interest individually it would have had he or she not actively participated in the business. Remember that the determination of what is required for a trust to actively participate to avoid the NIIT tax remains uncertain. The IRS rulings on this matter have been rather harsh.[52] Several court cases, however, have taken a positive view of a trustee's participation as characterizing a trust as active.[53] What if the trust involved is a directed trust and the general trustee is an institution that is not involved in management, but the investment adviser (or investment trustee) is actively involved? Does that suffice to characterize the trust as active to negate application of the NIIT? Another NIIT planning idea post-2017 Act is to distribute to a child beneficiary who would still have his or her own $200,000 MAGI bucket before a NIIT was incurred.

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[50] "For the 99.8 Percent Act," S. 309 116th Cong. (2019).
[51] Section 1411.
[52] TAM 200733023, and TAM 201317010. A national office technical advice memorandum (TAM) cannot be cited or used as precedent. Section 6110(k).
[53] *Mattie K. Carter Trust v. US*, 256 F. Supp. 2d 536 (N.D. Tex. 2003); *Frank Aragona Trust v. Comr*., 142 T.C. No. 9 (Mar. 24, 2014). Section 642(h).

Schedule Annual Trust Meetings: Proper Trust Operation is Vital to Achieving Intended Income Tax Status

It may not be sufficient to craft the trust instrument as a non-grantor trust, or to convert a grantor to non-grantor trust properly. The trust must also be administered in a manner that conforms to the non-grantor trust requirements. For example, if the trustee unbeknownst to the practitioner purchases life insurance on the grantor's life, and pays a premium, that might characterize the trust in whole or part as a grantor trust. What if a loan is made to the settlor and the interest rate or security is inadequate? Should loans be prohibited? Even if prohibited by the instrument the trustee's authorized action of making a loan might undermine the intended non-grantor status. If the instrument prohibits distributions to the settlor's spouse without the consent of an adverse party, what if the trustee makes a distribution without such consent? What if the trustee or a protector acts in a manner that suggests an implied agreement to benefit the grantor thereby undermining non-grantor status? Perhaps, new types of savings language should be added to non-grantor trust instruments? In all events, as the complexity and variety of trusts in a client's plan expands, the importance of annual reviews with counsel and the rest of the planning team becomes more essential. It may be more difficult for clients, and even some of the client's non-tax advisers, to differentiate grantor from non-grantor trusts, and to use the appropriate trust administration techniques for the right trust.

The *SEC v. Wyly* case continues to serve as a reminder about the importance of proper trust operation.[54] In *Wyly* the trust had trust protectors for each of 17 inter-vivos trusts. None of the persons serving as trust protectors were related or subordinate. Nonetheless the trustees followed all investment recommendations made by the protectors including with regard to collectibles, etc. The conduct of the trust protectors and settlors was such that the court imputed all actions of the trust protectors to the settlors since there was a pattern of action. While the *Wyly* case might be a bit extreme, the concept of a pattern of conduct is problematic in so many situations (e.g., a pattern of distributions from a trust that is then attacked in a later divorce). Clients too often do not understand the need to meet annually with legal counsel to identify inadvisable patterns of distributions, payments, investments, etc. Even if *Wyly* is viewed as an outlier, its lesson is nonetheless important. Adhering to formalities, and conducting meetings with the professional adviser team to address distributions, payments and investments remains important.

Converting/Toggling from Grantor to Non-Grantor Status

To convert an existing grantor trust into a non-grantor trust, the grantor, and perhaps the grantor's spouse, may have to release all the powers in the instrument that would cause it to be treated as a grantor trust. Once the original settlor renounces all grantor trust powers, the planner must confirm that Section 678 will not cause the trust to be treated as a grantor trust with respect to any beneficiary. By way of example, so-called *Crummey* powers[55] in the instrument can cause the trust to be deemed a grantor trust as to the *Crummey* power holders to the extent of their withdrawal powers if the settlor cannot be treated as a grantor.

[54] *SEC v. Wyly et al*, No. 1:2010cv05760 - Document 622 (S.D.N.Y. 2015).

[55] That is, those powers granted to a beneficiary enabling her to withdraw property from the trust generally in order to qualify all or a portion of a gift for annual gift tax exclusion.

Can you merge/convert/decant an existing grantor trust into a non-grantor trust? What about a non-grantor trust being converted to a grantor trust via a decanting for example? Clearly with the changes in the law one characterization may have been preferable in the past, but a different characterization may be more advantageous now, and if the individual tax changes sunset in 2026 yet a different characterization may be more important then. Practitioners might consider approaches that incorporate flexibility for this type of planning in trust instruments. For example, a power to swap assets and to lend without adequate consideration should be excluded if non-grantor trust status is desired. What if a named individual was empowered as a non-fiduciary to add these rights back into the trust, if appropriate, at a future date? If that is done, might the IRS argue that there was an understanding or implied agreement with the power holder?

Converting a non-grantor trust to a grantor trust should not have any adverse income tax consequence, unless some special rule applies, by way of example, when a non-grantor trust holds the right to income in respect of a decedent, such as when a trust owns an interest in an IRA.[56] If a non-grantor trust is converted to a grantor trust the non-grantor trust should file a final income tax return through the date of conversion. All income should pass to the new grantor trust.

Converting from a grantor trust to a non-grantor trust also may, however, trigger income tax costs, e.g. if there are liabilities in excess of basis.

> **Example**: Client engaged in note sale transaction with a grantor trust several years ago. The client sold a highly appreciated interest in a family business to a grantor trust for a note. Post-2017 Act the client believes non-grantor trust status would provide additional state income tax savings and Section199A deductions and converts the formerly grantor trust into a non-grantor trust. That conversion may trigger the gain on sale of the appreciated interest that had been avoided on the initial sale to the grantor trust.

If the individual income tax changes sunset in 2026 or are modified by future legislation, is the cost of complex planning to endeavor to capture current but potentially temporary income tax benefits worthwhile? In many cases it might be. Practitioners might contemplate possible sunset or changes in planning documents by empowering a trust protector or other person to turn on or off grantor trust status in order to convert a non-grantor trust into a grantor trust if the intended income tax benefits sunset. The IRS had held against toggling on and off grantor trust status, but the circumstances of that ruling were abusive and the same rationale may not apply to other situations, especially if the toggle is a result of a change in the law (e.g., the sunset of Act changes).[57] Incorporating a decanting power to facilitate the trustee converting the trust status via decanting might also be worth consideration. How effective will state efforts be to circumvent SALT (state and local tax) limitations? Does this obviate the need to plan or should planning be pursued as it may provide tax savings with greater certainty? At the time of this writing the outcome of these efforts is uncertain, there are certainly practitioners who are skeptical as to the efficacy of that planning.

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[56] PLR 200848017, CCA 200923024 cf. I.R.S. Notice 2007-73, 2007-36 I.R.B. 545. Cf. Rev. Rul. 77-402, 1977-22 CB 222.

[57] I.R.S. Notice 2007-73

Another issue might arise on conversion. Could it create a claim by a beneficiary against the trustee now that the trust or beneficiaries, not the grantor, have to bear the income tax burden? If that is envisioned and is of concern, it should be expressly authorized in the trust instrument and trustee liability waived for doing so as it may be in Alaska. However, in other states, the duty of undivided loyalty to the beneficiaries may not be waived – so caution is recommended.

Non-Grantor Trusts with Spousal Access Without Tainting Non-Grantor Status

A common planning technique, especially beginning in 2012 when taxpayers sought to use exemption before it purportedly would decline from $5 million to $1 million, is the use of non-reciprocal spousal lifetime access trusts ("SLATs"). In this technique each spouse creates a trust for the other spouse and descendants. The trusts are crafted to be non-reciprocal. Therefore, they need to have sufficient differences so that neither the IRS nor a creditor can "uncross" the trusts and undermine the planning. The benefit of the SLAT technique is that a couple can use exemption and retain (through his or her spouse) access to assets transferred, all while achieving asset protection goals. Planning in the current environment has important similarities and differences from the SLAT planning of 2012. The following highlights how planning might optimally be structured now:

- Like 2012, current wealth transfers might seek to secure the high estate tax exemptions before they are reduced by half in 2026 (or by legislation prior to that if there is a change in administration in Washington).
- Like 2012, but even more pronounced, is the need for most taxpayers using current exemption to have access to the assets transferred. The reason access is more important is obvious, the exemptions are larger, and more wealth can be transferred.
- Unlike 2012, SLATs in the current environment should in many, but certainly not all, instances be structured as non-grantor trusts to garner potentially a number of different tax benefits (even considering the 199A Proposed Regulations).

Threading the tax and trust "needle" to meet the above requirements requires a different type of trust, and different planning and drafting then has been historically common. Just as with the completed gift ING suggested above, a new variant of a spousal trust will be necessary to achieve the disparate goals above. This new variant has been referred to as a "SALTy-SLAT" by virtue of the non-grantor SLAT being able to facilitate planning to salvage some of the state and local tax ("SALT") deductions. Others have referred to it as a Spousal Lifetime Access Non-Grantor Trust ("SLANT"). Whether a new acronym is used, drafting non-grantor, completed gift, trusts that are accessible, is a technique to consider for some clients in the current planning environment.

If the trust is properly structured (no grantor powers to the settlor spouse) and the beneficiary spouse can only receive distributions with the consent of an adverse party, the trust may achieve all objectives: completed gift to use exemption, non-grantor trust for any or all of the planning benefits of non-grantor trust in the post-2017 Act environment, and access.

Don't Dismiss Using Non-Grantor Trusts to Enhance 199A

An important focus of the final corrected 199A Regs, is eliminating what the IRS perceived as abuses practitioners had discussed with the use of multiple non-grantor trusts to secure 199A deductions when the taxpayer herself may not have qualified.

> "Part I of subchapter J provides rules related to the taxation of estates, trusts, and beneficiaries. For various subparts of part I of subchapter J, sections 643(a), 643(b), and 643(c) define the terms distributable net income (DNI), income, and beneficiary, respectively. Sections 643(d) through 643(i) (other than section 643(f)) provide additional rules. Section 643(f) grants the Secretary authority to treat two or more trusts as a single trust for purposes of subchapter J if (1) the trusts have substantially the same grantors and substantially the same primary beneficiaries and (2) a principal purpose of such trusts is the avoidance of the tax imposed by chapter 1 of the Code. Section 643(f) further provides that, for these purposes, spouses are treated as a single person."

The Final Regulations attempt to quash the ability to use non-grantor trusts to circumvent the Section 199A threshold limitation and take a harsher view then the Proposed Regulations had.

> "The final regulations clarify that the anti-abuse rule is designed to thwart the creation of even one single trust with a principal purpose of avoiding, or using more than one, threshold amount. If such trust creation violates the rule, the trust will be aggregated with the grantor or other trusts from which it was funded for purposes of determining the threshold amount for calculating the deduction under section 199A."

The Final Regulations take a more stringent view of trusts used to circumvent the taxable income threshold under 199A so that even a single trust can be disregarded if it is created or funded to avoid the rule. For practitioners who created a non-grantor trust for this purpose, the Final Regulations should be re-evaluated to determine the impact.

The Final Regulations eliminated examples and discussions that the Proposed Regulations had contained concerning the use of multiple trusts to plan around the taxable income threshold for Section 199A purposes. The Final Regulations have deferred back to the statute, Section 643(f) on multiple trusts. The Final Regulations reflect that

> "…the Treasury Department and the IRS have removed the definition of "principal purpose" and the examples illustrating this rule that had been included in the proposed regulations, and are taking under advisement whether and how these questions should be addressed in future guidance. This includes questions of whether certain terms such as "principal purpose" and "substantially identical grantors and beneficiaries" should be defined or their meaning clarified in regulations or other guidance, along with providing illustrating examples for each of these terms. Nevertheless, the position of the Treasury Department and the IRS remains that the determination of whether an arrangement involving multiple

> trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f), in the case of any arrangement involving multiple trusts entered into or modified before the effective date of these final regulations."

The examples that raised concerns and the principal purpose test from the Proposed Regulations have been eliminated in the Final Regulations but practitioners have little more to rely on with respect to how multiple trusts will be treated other than the bare language of Section 643(f).

New Spin on the Beneficiary Defective Irrevocable Trust ("BDIT") to Save State Income Taxes

Might a variation of the Beneficiary Defective Trust ("BDT") be used to achieve new planning goals to address the SALT restrictions of the Act? A BDT is an irrevocable trust that is a grantor for trust for income tax purposes as to the beneficiary and not as to the settlor. For example, a parent may set up a trust for child, and that trust could be crafted to exclude provisions that would make the trust a grantor trust as to the settlor. The trust would include an annual demand or *Crummey* power, making the trust have grantor trust status as to the child/beneficiary.

In the traditional BDT (or "BDIT") the parent may create a BDT for a wealthy child with a $5,000 initial gift, which would be subject to the child's power of withdrawal which would lapse without gift or estate tax consequences but would remain a grantor trust as to the child so that he or she could sell assets to the trust without triggering capital gain. A good plan, but how can this be spun for the 2017 Act?

If the parent lives in a high tax state and the child in a no tax state, might a variation of the typical BDT approach be used by the parent to shift income to a lower SALT environment to save SALT when they are no longer deductible? This approach might shift the focus of a BDIT plan from estate tax savings or asset protection to state income tax savings.

> **Example**: Mom gifts $5,000 to a BDIT that is a grantor trust as to son who resides in a low tax state. Mom then directs business opportunity to the trust which has no discernable gift tax value. The income generated will be reported by son in the no tax state. This may provide an overall state income tax savings to the family unit which could be more valuable post 2017 Act because of the SALT limitation. The value of the business opportunity could be grown outside the parent and child's estate in contemplation of the sunset of the estate tax repeal.

Not Every Trust Should be a Non-Grantor Trust

Given the enhanced benefits of using non-grantor trusts post-2017 Act, articles and webinars have extolled the new benefits of using non-grantor trusts. But a broader and more balanced view of the decision process as to whether a grantor or non-grantor trust should be used is recommended. Not every trust should be structured, or re-structured, to be a non-grantor trust. Planners will likely find that there will be a more diverse array of trusts in many client's plans consisting, depending on each particular client's circumstances, of a combination of grantor and non-grantor trusts and perhaps new types of trusts designed to meet current planning objectives.

Prior to the 2017 Act, most irrevocable trusts were structured as "grantor" trusts for income tax purposes. With a grantor trust the settlor bears the income tax cost of the income earned by the trust. This so-called grantor trust "tax burn" (of the settlor paying income taxes on income earned by and retained in the trust) further reduces the size of the settlor's estate without bearing additional gift tax consequences. The settlor could retain the power to swap or substitute trust assets for personal assets and use it to shift appreciated assets from the trust into his or her estate to gain a basis step up on death. Appreciated assets could be sold to the trust to lock in discounts and shift future appreciation outside the estate without triggering capital gains.

For some clients the continued use of grantor trusts will remain optimal, at least for some of their planning. Existing trusts to which note sales were made of appreciated assets may not be able to convert to non-grantor trusts without triggering tax costs. For very high net worth clients the ability to sell assets to a grantor trust might justify retaining or creating a grantor trust.

If a trust owns S corporation stock, forming a non-grantor trust (or the conversion from a grantor trust to a non-grantor trust) will require conforming to the qualified Subchapter S trust ("QSST") or electing small business trust ("ESBT") requirements. It may be preferable for the donee trust to be characterized as a grantor trust rather than meeting QSST or ESBT requirements.

Will the client accept the steps necessary to make a trust a non-grantor trust? For a non-grantor SLAT (a so called "SALTy-SLAT"), is the client comfortable having a child/beneficiary as an adverse party approve distributions? While some may, many may not. Even if the client is agreeable, will designating a child remainder beneficiary to hold an approval power over distributions to the settlor's spouse suffice to constitute an "adverse party" for these purposes to assure non-grantor status? The Regulations require that the adverse party have a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power.[58] There is, unfortunately, little clarity on the delineation of what is "substantial." Thus, there may be more risk in the use of the adverse party mechanism to preserve or achieve non-grantor trust status then many realize. Is instead of using this technique giving a person in a non-fiduciary capacity a special or limited power to appoint to the spouse a better option? That technique might also be subject to a potential challenge based of an implied agreement between the power holder and settlor (or spouse).

Is an incomplete gift non-grantor ("ING") structure a safer approach to addressing the need for an adverse party as contrasted with the non-grantor SLAT approach of perhaps naming one adverse party? The answer is not clear. Also, given the approach taken in the proposed Section 643(f) multiple trust regulations, will the IRS continue to issue ING private rulings if it is concerned about the abuse of non-grantor trusts post-2017 Act? Will the complexity of making the transfer to an ING trust a completed gift to use temporary exemption outweigh the advantages? Will the ING characteristic of a distribution committee (aka power of appointment committee), discussed below, add too much cost, complexity or administrative burden for some clients to accept?

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[58] Reg. 1.672(a)-1(a).

Consider the Sanders tax bill proposal. Perhaps it may be more advantageous to structure a grantor trust that might still be grandfathered and exempted from future harsh legislative changes.

Consider Structuring a Community Property Trust for Basis Step-up on First Death

Practitioners might consider planning to use community property rules to obtain a full basis step up on the death of the first spouse to die (subject to the normal exceptions, such as for income in respect of a decedent).

While there are 11 states with community property laws, three of the states provide elective community property laws that anyone can avail themselves of: Alaska, Tennessee and South Dakota, with others contemplating adding such provisions to their statutes.[59] Some commentators have different views as to the effectiveness of these statutes for non-residents of those states, but that discussion is beyond the scope of this article. Residents of non-community property states, for example, might create a community property trust in Alaska in an attempt to obtain a full basis step up on the first spouse's death on all assets held in that community property trust. In reality, it is not a step up but more akin to a mark to market regime as basis can be stepped down as well. This technique can be valuable for many client situations. Further, later estate tax minimization planning might proceed without being hindered by low basis issues on those assets.

> **Example.** If a highly appreciated rental property or business interest is transferred to an Alaska community property trust by a domiciliary of a non-community property state, e.g. New York, on the death of the first spouse the entirety of that asset would benefit from a basis step-up.[60] Thereafter, one-half of the assets, with a basis equal to fair value, could be distributed to the estate of the first spouse to die (of which the surviving spouse could be the beneficiary) and one-half to the surviving spouse, to achieve a full step up in basis on the death of the first spouse to die.

For a non-resident of Alaska to create an Alaska community property trust as discussed in the above illustration, a requirement to benefit from the Alaskan law is to name a qualified trustee as an administrative trustee (e.g. an Alaskan trust company).

Consider Modifying Planning in Light of Possible Democratic Estate Tax Changes

Practitioners should consider the impact of the upcoming national elections in 2020 upon planning for their UHNW clients, particularly in the wake of the so-called Blue Wave from the

[59] In Alaska, Tennessee, and South Dakota, an individual need not be a resident of the state in order to avail herself of the benefits of a community property laws in such state.
[60] Section 1014(b)(6).

2018 mid-term elections when the Democratic party flipped an unprecedented number of seats in the House of Representatives to reclaim the majority.

Though the Democratic electorate has been showing some signs of Bernie fatigue, the surge of other progressive presidential candidates like Senator Elizabeth Warren make the passage of tax reforms targeting UHNW clients, enhance the possibility that something akin to Senator Bernie Sanders' proposed tax act entitled "For the 99.8 Percent Act" might all but eliminate the opportunities currently available to those clients.

Practitioners should caution clients that it might be advisable to implement planning in advance of the election.[61]

Consider Downstream Planning (not Upstream) for UNHW Clients

A valuable "asset" of many UHNW families is the unused exemption of their children. But in many cases children of even UHNW families do not have sufficient resources to make gifts to use their exemptions. If the parents endeavor to loan funds to the child so that the child can make gifts to use exemption those loans may be re-characterized as a gifts, triggering gift tax on a purported loan re-characterized as a gift. Perhaps an alternative might be for an existing dynasty trust, of which the children are beneficiaries, to guarantee the loan so that it may in fact be characterized as a loan. The child/borrower may then use the funds to consummate a gift.

Be Wary of Risks of Upstream Planning

Upstream planning, to shift values to a higher generation family member not subject to the estate tax has been discussed by a number of commentators. This type of planning has been given considerable attention in light of the current large temporary exemptions. Clients who have a net worth substantially in excess of the approximately $22 million per couple exemption, might consider upstream planning if, for example, the client's parents have a net worth combined of well under the current exemption, e.g. only $2 million.

Upstream planning might be affected by the clients creating a GRAT that is calculated to vest in each parent somewhat less than the maximum amount which, when added to their other assets, would not exceed each parent's estate tax exemption at the time that each parent dies. The parents can revise their estate planning documents to bequeath the remainder interest to a trust for the benefit of the client and the client's descendants. This transfer might not only absorb the parent's estate tax exemption but might utilize each parent's GST exemption (because there is no ETIP with respect to the parent as beneficiary of the upstream GRAT). The IRS might have no objection to this planning because it actually uses exemption, rather than being an assignment on day one (or two) of a nominally valued remainder interest.

[61] Portions based on: Shenkman, Tietz and Blattmachr, "The Bernie Sanders Estate Tax Proposal - Might it Foreshadow Future Democratic Proposals?," Estate Planning Newsletter #2715 (April 4, 2019).

Another approach to upstream planning is to create an irrevocable trust with a general power of appointment ("GPOA") to a person living in a non-decoupled state who has a modest estate of her own. The presence of that GPOA should cause estate inclusion of trust assets in that person's estate generating no estate tax but an adjustment of basis on her death.[62] This type of GPOA planning raises a host of questions to consider.

How can protection before afforded against an unintended or undesirable exercise of the GPOA granted? For example, the exercise of the GPOA could be conditioned upon the consent of a non-adverse party providing a measure of protection. Instead of a GPOA, a limited power of appointment ("LPOA") could be provided to that intended person, and another person can be given the power, in a non-fiduciary capacity, to convert the LPOA into a GPOA before the powerholder's death. If the trust is formed in a jurisdiction that permits silent trusts, is there a need to even inform the power holder of the existence of the GPOA? The scope of the GPOA could be limited. For example, the power holder may only be granted the right to appoint to the creditors of her estate and to the descendants of the grantor of the power or trusts for their benefit.

This type of upstream GPOA planning might raise creditor issues. Confirm that the existence and exercise of the GPOA will not subject the trust assets to the claims of the creditors of the powerholder. If that is a risk, might conditioning the exercise of the power on the powerholder being solvent limit such risk? A GPOA may also subject the assets to a parent's or other power holder's Medicaid claim for reimbursement.[63]

Although many practitioners have touted the use of "upstream" planning to salvage otherwise unusable exemptions that elderly relatives of clients have, the planning is not assuredly beneficial. Consider the consequences of upstream planning if there is a Democratic victory in 2020 and a proposal like the one touted by Sanders is enacted. For example, if a parent had an estate of only $4 million, and the child created a trust with $7 million and gave his parent a general power of appointment ("GPOA") over that trust. The intent of the plan was that the parent's estate would include the assets in the trust and those assets would garner an estate tax free adjustment (hopefully step-up) in income tax basis on parent's death. If the exemption is reduced to the $3.5 million as in the Sanders Act, the plan intended to garner a basis step-up at no tax cost may instead trigger a substantial estate tax cost that was unintended.

Practitioners should carefully review any upstream planning that in an attempt to avoid this result. For example, the elderly parent could be granted a limited power of appointment and someone given the right to convert that to a general power of appointment. If the exemption is reduced the conversion would not be triggered. While many such upstream plans were likely crafted to only include in the senior generation's estate an amount that does not trigger an estate tax, the more prudent course of action would be to confirm that. Clients who only recently had planning updated to address the inclusion of GPOAs to a higher generation will likely be frustrated by the yo-yo tax law changes and ongoing planning updates.

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[62] IRC Sec. 2041.

[63] Acknowledgement to Bernard Krooks, Esq. for this caution.

Credit Shelter Basis Planning Risk

Many practitioners may advise to terminate credit shelter trusts or distribute appreciated assets out of a credit shelter trust in order to garner a basis step up on the death of the surviving spouse. If a Sanders type bill is enacted after the 2020 election that could prove a costly. While terminating or distributing assets out of a credit shelter trust to gain a basis step up might be advantageous with an $11.4 million exemption, it could prove to be a very costly gambit if the surviving spouse dies after the exemption drops.

Maximize GST Tax Planning Before Potential Changes

Another foundation of planning has been to shift value to an irrevocable trust and allocate generation skipping transfer ("GST") tax exemption to the trust. Properly done under the current system, the value of assets in that GST exempt trust, no matter how much they appreciate, should never be subject to the transfer taxation system. The compounding of wealth outside the estate tax system can provide incredible wealth shifting opportunities. When this is coupled with a long-term trust (dynastic trust) wealth may compound outside a client's estate forever. The Sanders proposal appears to limit the application of the GST exemption to a maximum of 50 years. That change would hinder this type of planning and might result in a costly tax after 50 years of a trust's existence. If a change along the same lines as this proposal is enacted, but if it "grandfather's" existing trusts (i.e., the new restrictions only apply to trusts formed after the new law), many people, even those of moderate wealth, might benefit from creating long-term dynastic trusts now.

Grantor Retained Annuity Trusts ("GRATs")

A key benefit of GRATs is that clients can create these trusts to shift wealth out of their estates without using any (or any material) part of their gift tax exemption, to the extent the assets in the trust grow at a rate above the so-called Section 7520 rate (a relatively low rate the IRS announces each month). Many, perhaps most, GRATs were structured by practitioners as so-called zeroed out GRATs. This meant that the annuity payment the trust made to a client as the grantor creating the trust equaled (or almost equaled) the value of assets gifted to the trust. Upside appreciation (above the rate of return the IRS required be used in the technique) would inure to the beneficiaries of the GRAT with no gift tax cost. The Sanders' proposal would perhaps eliminate the viability of this technique in many cases by requiring a minimum 10 year term for any GRATs created after the enactment. If a client does not outlive the term of the GRAT, some or all the assets (generally) are included in the client's estate. That would dramatically increase the risk of a GRAT succeeding. The proposal also contains a minimum required gift amount, effectively removing the ability to have a zeroed out GRAT. These two changes could potentially make GRATs impractical for very wealthy taxpayers that have traditionally used GRATs when they no longer had gift tax exemption remaining. It would also seem to eliminate the commonly used technique of "rolling-GRATs", where practitioners would create a two year GRAT and the client would "re-GRAT" each annuity received to a new GRAT and continue to shift appreciation beyond the Section 7520 rate out of the estate taxation system.

Practitioners should consider this if planning to use GRATs now. If rolling those GRATs is eliminated in but a few years the plan may not work as anticipated.

Crummey Powers, Powers of Attorney and Insurance Trusts

Another common planning tool has been for clients to make gifts to trusts from which a class of beneficiaries can withdraw a pro-rata portion of the gift made by the grantor, up to the annual gift exclusion amount for that beneficiary. This has facilitated the ability for clients to make large gifts to a trust, e.g. used to buy and hold life insurance, and not incur any gift tax cost related to the gift. The Sanders proposal has proposed eliminating this technique by restricting annual gifts to $10,000 per donee and a maximum of $20,000 per donor. If this applied to all trusts after enactment, the results could eliminate the common Irrevocable Life Insurance Trust ("ILIT") which has been ubiquitous in estate plans. Practitioners might discuss with their clients implementing an ILIT so it is in place before any changes are made to existing law, in case existing trusts are grandfathered (i.e., exempted from the new change). Clients might also consider making large gifts now (using that exemption that might also disappear) so that they won't have to rely on annual gifts to fund their life insurance premium payments.

> **Example**: Client has a typical ILIT with *Crummey* powers. Premiums are $75,000/year and are easily covered by the annual demand powers available to children and grandchildren who are beneficiaries of the trust. If tax reform like the Sanders plan is enacted and *Crummey* powers are prospectively eliminated (even for trusts predating the law change), the client will not be able to fund premiums without incurring a costly current gift tax. The client might be able to transfer a sufficient amount of marketable securities to the trust now, using her exemption, so that the future premiums can be paid from a combination of the income and principal of the gift made. If this technique is pursued, it might also be worthwhile to inquire about prepaying future premiums currently to minimize future income tax costs to the client. Practitioners might also wish to consider modified endowment contracts and other implications.
>
> **Another Example**: Since GRATs may also be on the chopping block, a wealthier client who does not have adequate exemption remaining to complete a large gift as in the prior example, might create and fund a GRAT that pours into the ILIT (a common approach when exemptions were lower for a non-GST exempt ILIT). The GRAT could endeavor to shift value to the ILIT to avoid the gift tax issues should *Crummey* powers be eliminated. This type of GRAT/ILIT plan might also be structured different than such plans had been historically. The traditional GRAT/ILIT plan would have entailed creating a two year GRAT with the ILIT as the beneficiary. Each time an annuity payment was made, the client would re-GRAT the annuity into a new GRAT also benefiting the ILIT. But if GRATs are slated for restriction (as in the Sanders' proposal) then perhaps a tier of GRATs with different terms might be created now, before the new GRAT restrictions are enacted, so that the existing GRATs may be grandfathered and continue to fund insurance premiums for years to come despite the restriction on *Crummey* powers.

Practice Safer Estate Planning

Malpractice risks and issues are significant. Safer practice is worth considering by all advisers, including not just attorneys and CPAs, but banks, trust companies, wealth advisers and more. Despite (or perhaps especially because of) such significant pressure for billable hours and revenue generation (whether as hours billed or assets under management or otherwise) every one of the allied professions might wish to reassess its practice methods and in particular disclaimers. Consider some of the following possible steps based on recent cases:

- Consider adding cautionary language to cover letters.

  Sample Clause: "*Estate planning is inherently complex, subject to varying interpretations. Applicable federal, state and local laws change frequently. Ongoing review and maintenance of every plan and document is essential. There is no assurance that any particular result will be realized. There are risks and negative consequences to every planning step and technique. It is impossible to enumerate all of the risks and consequences in any communication. There is a possibility that a great planning strategy today will be nullified by a new rule, law and/or a court case tomorrow. By proceeding with this planning, you accept these risks.*"

- Consider adding cautionary language to retainer agreements or footers on bills, or both.

  Sample Clauses:

  *"**Risks; No Guarantees**: You understand and acknowledge: Results of any plan are never guaranteed. Numerous aspects of many, if not most, estate and related plans are not only uncertain, but subject to a wide spectrum of different views by other advisers, the courts, the IRS, and other authorities. Most strategies have negative consequences (e.g. save estate tax, lose basis step-up). Many common strategies, techniques and transactions are subject to tax, legal, financial, and other risks and uncertainties. While we endeavor to identify some of the risks of a plan, all risks and issues with each component of a plan are not possible to identify or communicate. Creating a collaborative team may help identify more issues with your plan. Further, the fact that we communicate verbally or in writing certain risks should never be interpreted as an indication that any such listing or communication is a complete listing of every risk involved. The risks of any transaction can be further compounded by improper administration of the plan, failure to meet annually to review and update the plan, or changes in the tax and other laws that may reduce (or eliminate) any projected benefits. Such risks may even result in more costly results than had no planning been pursued.*

  ***Audit and other Risks**: Any estate or transaction may be subjected to audit which creates a risk of undesired or unintended consequences. Possible challenges may* *emanate from risks we communicated to you, while others may not have been discussed. Challenges by the government as part of the audit process might cause inclusion of assets previously transferred out of your estate in your estate. After audit, assets that had been transferred out of the estate as part of the recommended strategies may be adjusted to their date of death value, which could result in tax related liabilities such as those attendant to capital gains, depreciation recapture, and/or a negative capital account. You agree that we shall not be liable for any assessments of tax, interest, or penalties resulting from our recommendation or your decision to implement any strategy."*[64]

- Consider adding cautionary language as a preamble to estate planning and other memorandum.

Sample Clauses:

*"**Disclaimer Statements and Risks***

***Limitation to Client**: This Planning Memorandum is solely for the benefit of the client named above and is not to be relied upon by anyone else without the written consent of [Law Firm]. Any strategies suggested are intended solely for the use of the client named above, and cannot be relied upon by others. The strategies discussed are for purposes of attempting to achieve the client's goals, which may differ from outcomes desired by a beneficiary.*

***Not A Legal Opinion**: The following memorandum outlines and weighs various techniques, considerations and/or options. Often there is no single correct answer and the law with regard to the application of those options is unsettled. Therefore, unless specifically stated to the contrary, this memorandum is not a formal legal opinion regarding the potential tax consequences or ultimate feasibility of the strategies discussed herein. The following memorandum presents discussions of options and certain issues, **not** conclusions of law. If you want a formal legal opinion upon which to rely you must separately engage us to render such an opinion. The rendition of such an opinion is not feasible in all instances. Bear in mind that significant additional cost will be incurred regardless of whether or not a favorable opinion can be reached, should one be requested. If you are not clear on the distinction and import of the discussion in this memorandum regarding the difference in discussing potential strategies and the rendition of a formal legal opinion, please call to discuss this.*

***Matters in Purview of other Advisers**: We advise you to consult with your accountant, tax advisors and other advisors as to the potential tax consequences of strategies addressed in this Memorandum. Although we may address certain*

[64] While attorneys may not be permitted to limit liability other professionals might benefit from the use of this type of clause.

income tax consequences, those matters are within the purview of your CPA and should be addressed as such. Although we may address certain insurance matters or investment matters, those matters are within the purview of your insurance and/or investment adviser, and should be addressed as such. Although we may address certain real estate or corporate (entity) matters, those matters are within the purview of your general counsel (or your specific real estate or corporate counsel) and should be addressed as such.

Information Will Not Suffice to Avoid Tax Penalties or Interest Charges*: The information in this memorandum, in any attachment, or cover letter (including previous and subsequent correspondence during this engagement) are not intended to be or used to: i) avoid any penalties imposed by the IRS or any state tax authority; or, ii) promote, market or recommend to any other party any tax-related matter such as an investment, product, service, advice or position.*

Scope Limitations*: The scope of this Planning Memorandum is expressly limited to the strategies or matters discussed herein. No other issues are considered and [Law Firm] assumes no responsibility beyond the issues to which this Planning Memorandum is devoted. Additionally, no analysis is provided on any of the following issues: (1) any impact of future legislation or other changes in the law, whether retroactive in nature or not; (2) any issues specifically excluded; (3) non-US taxes, or taxes in jurisdictions not specifically mentioned; (4) any taxes not specifically mentioned; (5) life insurance or other insurance selection; (6) recommendations of investment products, securities or strategies; (7) issues emanating from holding interests located outside of the United States; (8) Medicaid, elder law, supplemental needs or special needs planning; (9) qualified plan issues; (10) annuities; (11) valuation reports or issues; or, (12) any other matter not specifically covered in the Billing Arrangement documents or other communications.*

Law Changes*: The suggestions, analysis, and discussions contained in this Planning Memorandum are based upon the applicable federal, state and local tax and other laws in effect as of the date of this Planning Memorandum unless otherwise noted. Such authority may change in the future, and such change may be applied retroactively. A change in state law may impact income, estate or other tax consequences. [Law Firm] assumes no responsibility to update this memorandum, or notify you in any manner, if the applicable law changes. Federal and state taxing authorities, regulatory agencies, the IRS, and the courts are not bound by the analysis herein and may take very different views or interpretations of the law, the facts or both. The analysis contained herein supersedes all prior oral and written discussions, if any, pertaining to the issues involved and may be modified by subsequent communications. We may have suggested a number of strategies, but there is no assurance that the IRS or state tax authorities, other governmental agencies, regulatory bodies or courts will accept this analysis. While we have discussed a number of associated risks with you, possible challenges could be asserted which may not have been discussed or even contemplated. We are not* *responsible or liable, to any extent, for any gift tax, income tax or estate deficiencies or assessments, interest, or penalties that may arise, or the results of any court holding including the piercing or disregarding of entities, trusts or transactions.*[65] *There may now be proposed Federal, state tax or other legislation which, if enacted, could modify or eliminate the benefits of many strategies if not grandfathered. The IRS, state tax authorities, opposing counsel, and others have, and may continue to, attack various strategies and techniques that may be suggested in this Planning Memorandum.*

Your Responsibilities: *We have relied upon your assertion that the information, facts and assumptions provided are true, correct, and complete. However, we have not independently audited or otherwise verified any of the information, facts or assumptions. A misstatement or omission of any fact or a change or amendment in any of the assumptions we have relied upon may require a modification of all or a part of the discussions or suggestions contained in the Planning Memorandum. In addition, our suggestions and discussions are based on the facts and assumptions as asserted to us by you and are at best only current as of the date of this Planning Memorandum. We have no responsibility to update this Planning Memorandum, or otherwise notify you, for events, circumstances or changes in any of the facts or assumptions occurring after the date of this Planning Memorandum or the date of any communication to you. It is the responsibility of the client to engage [Law Firm] or another adviser to revisit these matters from time to time, especially if your planning, the discussions or suggestions contained in this Planning Memorandum are impacted by a change in your circumstances, or notification via general communication from our office or through the general media which indicates a change has or may occur that could impact your plan. It is your responsibility to consider all communications we disseminate as well as general media coverage of events and contact us should any perhaps apply to you, your planning or this Planning Memorandum.*

Options; Your Decision: *Although we attempt to aid you in the decision-making process, and may suggest alternative recommendations verbally or in writing to help you achieve your objectives, and assist you in understanding how well each alternative might meet your estate planning objectives, the responsibility for estate planning decisions is solely yours. These services are not designed, and should not be relied upon, as a substitute for your own judgment, nor are they meant to mitigate the necessity of ongoing review. These services are designed to supplement your own planning and analysis and aid you in achieving your objectives*."

Conclusion

[65] While provisions attempting to limit liability may be appropriate for some professionals, some believe that attorneys are not able to limit their liability by inclusion of such provisions.

Practitioners should inform and educate clients as to the unique nuances of the current planning environment, and the changes that may be in the offing. The scheduled reduction in the current exemption levels in 2026 is a critical planning consideration for many. The potential for massive tax changes if there is a change in administrations in Washington after the 2020 election is also important for many clients to consider, and perhaps take proactive steps now. In this environment there are a range of planning considerations that affect how practitioners might practice, estate tax minimization planning, income tax planning and more. This article has endeavored to identify some of the planning considerations practitioners might wish to consider in the current environment, but is not intended to be a substitute for the exercise of your own independent professional judgment.

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