Rocky Mountain Estate Planning Council

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Upstream Planning for Unused Exclusions And Other 2021 Planning Thoughts

TURNEY P. BERRY
Wyatt Tarrant & Combs LLP
Louisville, Kentucky

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PRELIMINARIES

I. New Planning Approaches

Given the large Applicable Exclusion Amount, it becomes clear that for even many traditional clients the estate tax has disappeared as a dominant issue. This was scheduled to change on January 1, 2026, with the sunset of the "double" exclusion and may change earlier with centralized control in Washington. President Biden and the leadership of the House and Senate have all, in different ways, signaled an intent to increase taxes on the rich whether taxes at death or income taxes. What form this will take is speculative.

Even if there were no changes to the estate tax, as 2026 approaches, absent change, we will be faced with enormous pressure to enable clients to make gifts to use the soon to sunset basic exemption amount. Laying the groundwork today for such a possibility seems wise.

Estate planners will focus more of the tax planning for clients on the income tax, rather than the transfer taxes. In particular, it is likely estate planning will focus on tax basis planning and maximizing the "step-up" in basis at death.

Because the "step-up" in basis may come at little or no transfer tax cost, estate planners will seek to force estate tax inclusion in the future.

The state of residence of the client and his or her beneficiaries will greatly affect the estate plan. For example, if a client is domiciled in California, and his or her beneficiaries live in California, then dying with the assets may be the extent of the tax planning. On the other hand, if the beneficiaries live in a state like Texas that has no state income tax, then transferring the assets out of the estate during the lifetime of the client may be warranted. As a result, estate planners will need to ask clients two questions that, in the past, did not significantly matter: (a) Where are you likely to be domiciled at your death? and (b) Naturally, at your death, your children, grandchildren, and other beneficiaries will be lovingly at your bedside, but where are they likely to be domiciled then?

II. Portability Planning

Portability, at least in theory, can provide additional capacity for the surviving spouse's estate to benefit from a "step-up" in basis with little or no transfer tax costs. The extent to which portability is being used is uncertain. The 2017 IRS statistical data showed only 681 nontaxable portability returns filed.

In traditional by-pass trust planning, upon the death of an individual who has a surviving spouse, assets of the estate equal in value to the decedent's unused Applicable Exclusion Amount fund a trust (typically for the benefit of the surviving spouse and, perhaps, descendants). The trust is structured to avoid estate tax inclusion at the surviving spouse's estate. The marital deduction portion is funded with any assets in excess of the unused Applicable Exclusion Amount. The by-pass trust avoids estate tax inclusion at the surviving spouse's estate. From an income tax standpoint, however, the assets in the by-pass trust do not receive a "step-up" in basis upon the death of the surviving spouse. Furthermore, while the assets remain in the by-pass trust, any undistributed taxable income above minimal amounts will be subject to the highest income tax rates at the trust level.

In portability planning, the decedent's estate would typically pass to the surviving spouse under the marital deduction, and the DSUE Amount would be added to the surviving spouse's Applicable Exclusion Amount. Because all of the assets passing from the decedent to the surviving spouse in addition to the spouse's own assets will be subject to estate taxes at his or her death, the assets will receive a "step-up" in basis. Additional income tax benefits might be achieved if the assets that would otherwise have funded the by-pass trust are taxed to the surviving spouse, possibly benefiting from being taxed a lower marginal income tax bracket. In addition, if the by-pass trust would have been subject to a high state income tax burden, having the assets taxed to a surviving spouse who moves to a low or no income tax state would provide additional income tax savings over traditional by-pass trust planning.

Of course, there are other considerations, including creditor protection, "next spouse" issues and potential "Medicaid" planning, which would favor by-pass trust planning. From a tax standpoint, the trade-off is the potential estate tax savings of traditional by-pass trust planning against the potential income tax savings of portability planning. Because the DSUE Amount does not grow with the cost-of-living index, very large estates will benefit more with traditional by-pass trust planning because all of the assets, including any appreciation after the decedent's death, will pass free of transfer taxes. On the other hand, smaller but still significant estates should consider portability as an option because the combined exclusions -- the DSUE Amount frozen but the surviving spouse's Applicable Exclusion Amount growing with the cost-of-living index – are likely to allow the assets to pass at the surviving spouse's death with a full step-up in basis with little or no transfer tax costs (unless the assets are subject to significant state death taxes at that time).

Estates where a surviving spouse may need to qualify for government assistance should consider a modified by-pass trust type planning; the trust for the surviving spouse is designed specifically with governmental assistance in mind. For example, perhaps a child or other person should be allowed to terminate the spouse's interest in the trust (or otherwise modify it). Consider a trust "for" the surviving spouse in which the descendants are beneficiaries. A trusted child or other person could have a lifetime special power of appointment in favor of anyone; that power would be exercised every month, quarter, or year in favor of the spouse until that was inappropriate. The spouse would say accurately that no trusts were for his or her benefit. For Medicaid purposes, trusts under Will are favored over trust agreements.

In evaluating the income tax savings of portability planning, planners will want to consider that even for very large estates, the surviving spouse has the option of using the DSUE Amount by making a taxable gift to a grantor trust. The DSUE Amount is applied against a surviving spouse's taxable gift first before reducing the surviving spouse's Applicable Exclusion Amount (referred to as the basic exclusion amount). The grantor trust would provide the same estate tax benefits as the by-pass trust, but the assets would be taxed to the surviving spouse as a grantor trust thus allowing the trust assets to appreciate out of the surviving spouse's estate without being burdened by income taxes. If the assets appreciate, then this essentially solves the problem of the DSUE Amount being frozen in value. Moreover, the grantor trust likely provides for a power to exchange assets of equivalent value with the surviving spouse who can exchange high basis assets for low basis assets of the grantor trust prior to death and essentially effectuate a "step-up" in basis for the assets in the grantor trust.

Although a "step-up" in basis is great in theory, no tax will be saved if there is a loss at the time of death resulting in a "step-down" in basis or the asset is income in respect of a decedent (IRD). Furthermore, even if the assets receive a "step-up" in basis, will anyone benefit? Many assets, like family-owned businesses, may never be sold or may be sold so far in the future that the benefit of a step-up is attenuated. On the other hand, if the asset that receives a "step-up" in basis is either depreciable or depletable under the Internal Revenue Code of 1986 (the "Code"), the deductions that arise do result in tax benefits to the owners of that asset. Similarly, an increase in the tax basis of an interest in a partnership or in S corporation shares may not provide immediate tax benefits, but they do allow additional capacity of the partner or shareholder to receive tax free distributions from the entity. These concepts and how certain assets benefit or don't benefit from the basis adjustment at death are discussed in more detail below.

Portability planning is slightly less appealing to couples in community property states because, as discussed below, all community property gets a "step-up" in basis on the first spouse's death. Thus, the need for additional transfer tax exclusion in order to benefit from a subsequent "step-up" in basis is less crucial. This is not true, however, for assets that are depreciable (commercial real property) or depletable (mineral interests). As discussed below, these types of assets will receive a "step-up" in basis but over time, the basis of the asset will be reduced by the ongoing depreciation deductions. As such, even in community property states, if there are significant depreciable or depletable assets, portability should be considered.

EASY STEPS

I. Generally

As discussed above, estate planning will increasingly focus on the income tax savings resulting from the "step-up" in basis. Estate planners will seek to maximize the "step-up" up in basis by ensuring that the assets that are includible in the estate of a decedent are the type of assets that will:

> Benefit from a "step-up" (avoiding the inclusion of cash or property that has a basis greater than fair market value)
>
> Benefit the most from the "step-up" (for example, very low basis assets, collectibles, and "negative basis" assets); and
>
> Provide significant income tax benefits to the beneficiaries (assets that are likely to be sold in a taxable transaction after "step-up" or depreciable/depletable assets giving rise to ongoing income tax deductions).

In addition to the foregoing, estate planners will increasingly seek to:

> Maximize the value of certain assets because the "step-up" in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes); and
>
> Intentionally create estate tax inclusion, especially if the decedent lives in a state with no state death tax and if the decedent has significant unused Applicable Exclusion Amount above his or her assets.

II. Swapping Assets With Existing Grantor Trusts

Many individuals have made significant taxable gifts, using all or a significant portion of their Applicable Exclusion Amounts. Many of those gifts were made to grantor trusts.

A common power used to achieve grantor trust status for the grantor trust is one described under section 675(4)(C) of the Code, namely giving the grantor, the power, in a non-fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value. For income tax purposes, transactions between the grantor and the grantor trust will be disregarded. As such, grantors may exercise the power to swap high basis assets for low basis assets without jeopardizing the estate tax includibility of the assets and without having a taxable transaction for income tax purposes.

To maximize the benefits of the swap power, it must be exercised as assets appreciate or are sold over time. When exercised properly, this can ensure that only those assets that benefit the most from the step-up will be subject to estate inclusion.

If grantor does not have sufficient other assets, repurchase will be difficult - although the donor could borrow cash from a third party. What are the results if cash is borrowed by the grantor, the grantor buys assets from the trust, the trust loans the cash back to the grantor, the grantor pays back the third party lender and, at death, the grantor's estate satisfies the note to the trust with assets having fair market value basis?

The income tax consequences if a note is used to repurchase property are uncertain because the trust's basis in note may equal grantor's original carryover basis in the asset given to the trust and now reacquired so paying off the note may generate gain. In other words, if grantor trust status terminates because the grantor dies, and the trust owns a note from the grantor – now the grantor's estate – the note likely does not receive a step-up in basis so when the estate pays it off the trust will have gain. A solution may be to have the assets in the grantor's estate, subject to the debt, pass to the obligee trust, although whether that cancellation of debt is tax free is uncertain.

Because the sudden or unexpected death of the grantor may make a repurchase difficult or impossible, estate planners may want to consider drafting "standby" purchase instruments to facilitate fast implementation of repurchase.

III. Should Valuation Discounts Be Undone?

Where assets have been divided among generations to create discounts, consideration should be given to undoing those arrangements if the effect is to depress the value of an estate below the amount of Applicable Exclusion Amount in order to increase the income tax basis of the assets.

Discount entities could be dissolved or restated to allow the parties to the entity to withdraw.

An option could be given to a parent allowing the sale of the parent's interest to a child or children for undiscounted fair market value at death. Giving such an option to a parent would be a gift unless accompanied by adequate and full consideration.

If undivided interests in property are owned, agreements could be entered into that require all generations to consent to the sale of the property as one tract if any one owner wanted to sell. Quite obviously such agreements may be contrary to other estate planning or ownership goals of the family.

The ability of the IRS to ignore provisions of an agreement that increase the value of assets in the hands of a parent, but not in the hands of a child, is uncertain. By its literal terms, section 2703 of the Code applies only to provisions that reduce value and to restrictions on the right to sell or use property. To illustrate, in Estate of James A. Elkins, Jr., et al. v. Commissioner, 140 T.C. No. 5 (2013), the Tax Court applied Code section 2703 to ignore a family co-tenancy agreement requiring all owners of fractional interests in art to agree before the art could be sold. The purpose of that agreement was to limit the marketability of a fractional interest.

But what might the effect on value be of an agreement which provided, instead, that any fractional owner could compel the sale of the entire asset? Similarly, a provision that allowed a shareholder in business to put stock to the business at death for fair market value would seem to be outside the scope of the section. In many instances, amending old agreements to include such provisions will be more likely to create a gift from the younger owners to the older than would terminating an old agreement and creating a new one.

IV. Moving Assets Up

Many clients who have taxable estates also have a surviving parent or parents (or grandparent) who lack a taxable estate. A child of a parent whose taxable estate is less than the parent's Applicable Exclusion Amount may make use of the excess to save income, estate, and generation skipping taxes if the child can transfer assets upstream, from child to parent, in such a way that the assets are included in the parent's estate with little likelihood that the parent will divert the transferred assets away from the child or child's descendants. Although the benefits of such planning have always existed, the permanent increase in the Basic Exclusion Amount has enhanced the benefits of such planning.

To the extent a child transfers assets to an ancestor, the ancestor will include those assets in the ancestor's estate and may shelter those assets with the ancestor's estate and GST tax exemptions. Transfers can be made without using the child's Applicable Exclusion Amount as discussed below:

Annual exclusion gifts may be made to the ancestors. The gifts may be made outright or in trust depending on circumstances (e.g. ancestors may be given Crummey withdrawal rights). Discounted gifts may be made although doing so will add benefits to the transaction only if the discount is unlocked prior to the ancestor's death. The benefits of annual exclusion gifts may be significant.

Child could make adjusted taxable gifts to the ancestor. Although it may appear that such would be a wasted use of the child's gift tax exemption, if the ancestor is able to leave the $1,000,000 to child and child's descendants without estate or generation-skipping tax then the only waste would be opportunity cost to the extent that other methods could be found to transfer assets to a parent without making a gift.

Child may create an Upstream GRAT that has a vested remainder in ancestor. That is, the GRAT assets, after the annuity term ends, will be paid to ancestor or to ancestor's estate. The value of the remainder will be included in the ancestor's estate and will pass in accordance with the ancestor's estate plan.

The ancestor's executor may allocate generation-skipping tax exemption to the remainder interest without regard to any ETIP under section 2642(f) of the Code because the ancestor has not made an inter vivos transfer of property that would be included in the estate immediately after the transfer. The amount allocated would be equal to the fair market value of the remainder interest. Where the GRAT term is 10 years (or longer), and is back-weighted, the remainder value will remain a comparatively small percentage of the GRAT for the first several years of the term. Upstream GRATs will, in general, have longer terms than GRATs that are designed to transfer assets immediately to children. Commentators have speculated that a GRAT may be created with a vested interest in a child, with that child immediately transferring the remainder interest to that child's children and allocating that child's GST exemption at the time of transfer. There is no authority on whether such a transaction achieves the intended result. PLR 200107015 ruled negatively on the assignment of a remainder interest in a charitable lead annuity trust primarily on the grounds that section 2642(e) of the Code is specifically designed to limit the ability to leverage generation skipping tax exemption by using a charitable lead annuity trust. Here the GRAT remainder is not being transferred at the time of its creation, but rather at its fair market value at a later time (the death of the parent owner), which is not abusive. Suppose the GRAT remainderman is an LLC; could the LLC be transferred more easily than as a remainder interest?

Use of an Upstream GRAT presents several advantages compared with a child's assignment of a remainder interest to grandchildren. Because GST exemption that would otherwise be wasted is being used there is no, or certainly less, pressure to keep the remainder interest in parent's estate at zero or a de minimis value and the value changes depending on when parent dies (a date that in almost all instances will be uncertain). If a concern is that the value of the remainder interest could exceed the threshold beyond which parent's estate would be required to pay Federal estate tax (or file an estate tax return), then the amount vested in parent could be fixed by a formula tied to the remaining assets in parent's estate. Suppose a 10 year GRAT is funded with $1,000,000 with annual payments that increase at 20% per year is created in a month when the section 7520 rate is 2.0%. The first payment will be $44,125. Further, suppose that parent dies at the end of year 5 when the section 7520 rate is 5.0% and the value of the trust assets have grown at 6% per year. The value of the GRAT will be $975,740 with five years of payments remaining and the value of the remainder will be about $403,000.

General Powers of Appointment may be used in many ways to "move assets up" and these will be discussed in some detail in the following section. Note in particular the Delaware tax trap, the UPSPAT, and the Circumscribed Power of Appointment.

POWERS OF APPOINTMENT

I. Basic Principles

A. Introduction.

The vast majority of powers of appointment are non-fiduciary powers of disposition over property. The power is granted by the owner of property—the "donor"—in a will or trust and is given to a person traditionally called the "donee" in the Restatements of Property but called the "powerholder" in the Uniform Powers of Appointment Act ("Uniform Act") promulgated by the Uniform Law Commission in 2013 (see www.uniformlaws.org for extensive information about all uniform acts, including the text of and comments to the acts and enactment information). A powerholder appoints property to an appointee who must be a "permissible appointee," and the person who would receive the property if no appointment is made is the "taker in default." By describing these powers as non-fiduciary, we mean that the powerholder may exercise the power within its stated limits to the same extent that the powerholder could dispose of his or her own property. Thus a non-fiduciary powerholder does not have a duty to act in the best interests of the permissible appointees and in fact may exercise the power maliciously as long as any limits on the power are respected and the exercise does not violate public policy. A power of appointment may be granted to a trustee in a fiduciary capacity, but this is less common and not what we generally mean when we address powers of appointment.

A power of appointment may be exercisable currently or upon the occurrence of a specified event, the satisfaction of an ascertainable standard, or the passage of a specified time. A power that is exercisable currently is a "presently exercisable" power of appointment. Many powers of appointment are exercisable at the death of the powerholder, and these are referred to as testamentary powers of appointment.

There are general and non-general powers of appointment. The latter are sometimes referred to as "special" or "limited" powers of appointment but these terms can be confusing. A general power of appointment at common law was a power that had no restrictions on permissible appointees. However, since the 1940s, transfer tax law has defined a general power as a power of appointment exercisable in favor of any one or more of the powerholder, the powerholder's estate, a creditor of the powerholder, or a creditor of the powerholder's estate. For this reason, today we typically draft general powers to expressly so provide. At common law, a non-general power of appointment was called a "special" power and had limits as to the permissible appointees, such as the powerholder's descendants. However, the tax distinctions between general powers and non-general powers law has resulted in powers limited to specific persons or classes, or are the broadest non-general powers allowed by tax law. A right to withdraw assets from a trust is considered a general power of appointment because withdrawing assets is the equivalent of appointing those assets to the powerholder.

Powers of appointment may be imperative or non-imperative. As the name suggests, imperative powers must be exercised. If the donee of the power fails to exercise it, a court having jurisdiction over the trust (or the property) will exercise it. Non-imperative powers, by contrast, need not be exercised. Where takers-in-default are identified, the power almost certainly will not be viewed as imperative.

While non-imperative powers are much more common, imperative powers may have utility in certain planning scenarios. A relatively common imperative power occurs where the trustees of a trust are instructed to transfer property to one or more charities at the termination of a trust, under which no alternative disposition of the property has been made. For example: "Upon termination of the trust, if no descendant of mine is then living, the trust corpus and income shall be distributed to such one or more charitable organizations, transfers to which are deductible for federal income tax purposes, as my trustees then acting shall select and in such amount or proportions as my trustees shall determine, in the exercise of their sole and absolute discretion." This is an example of a power held by a trustee that is subject to fiduciary duties.

B. <u>The Doctrine of Relation Back.</u>

As a technical matter of property law, there is no doubt that a powerholder — as such — is not the owner of the appointive assets. The distinction between beneficial ownership and a power is stated in the Restatement Third of Property: Wills and Other Donative Transfers ("Restatement Third") §17.1 comment c:

> The beneficial owner of an interest in property ordinarily has the power to transfer ownership interests in or confer powers of appointment over that property to or on others by probate or nonprobate transfer.... By contrast, a power of appointment traditionally confers the authority to designate recipients of beneficial ownership interests in or powers of appointment over property that the [powerholder] does not own.

Upon the exercise of a power of appointment, the *doctrine of relation back* provides that the appointed property passes directly from the donor to the appointee. The powerholder's appointment is deemed to relate back to and become part of the *donor's* original instrument. The powerholder is viewed as akin to the donor's agent, as it were; an appointment retroactively fills in the blanks in the original instrument.

Technical ownership aside, when it comes to federal taxation and the rights of the powerholder's surviving spouse and creditors, the law does not always follow the relation-back doctrine. The likelihood that the powerholder will be treated as the owner of the appointive property is greater in the case of a reserved power, as distinguished from a power conferred on the powerholder by another. We discuss issues of taxation, creditors' rights, and the surviving spouse's elective share later in these materials.

C. <u>Tax Treatment of Powers of Appointment.</u>

Section 2041 of the Code defines a general power in the manner explained above. There are numerous cases and rulings dealing with whether powers are general. For example, in <u>McMullen v. Commissioner</u>, 56 T. C. M. 507 (1988), the court held that the power to appoint to the powerholder's "heirs or devisees" was a general power.

However, section 2041 excepts three circumstances from the definition of general power:

> 1. if the powerholder's authority is limited by an ascertainable standard relating to the powerholder's health, education, support or maintenance (see Treas. Reg. § 20.2041-1(c)(2) for further elaboration on what is, and is not, an ascertainable standard, discussion of which is beyond the scope of these materials);
>
> 2. if the power is exercisable only in conjunction with the donor of the power; or
>
> 3. if the powerholder can exercise the power only in conjunction with a person holding an adverse interest in the property (typically the takers in default; see Revenue Ruling 79-63 and Greve v. Commissioner, T.C. Memo. 2004-91 for a discussion of this issue).

Section 2041 requires the estate of a powerholder to include all property over which the powerholder has at death a general power of appointment. Mere existence of the power is sufficient, even if the powerholder does not know about the power or is incapable of exercising it at death (for instance, due to incapacity). *See* Estate of Freeman v. Commissioner, 67 T. C. 202 (1976); Rev. Rul. 75-350 (marital trust deduction allowed where surviving spouse was mentally ill during term of the trust); Rev. Rul. 75-351 (minor had a general testamentary power of appointment even though minor couldn't execute a Will as a minor).

Section 2207 provides that a powerholder's estate may recover from the recipient of property subject to a general power unless that right of recovery is waived by the powerholder/decedent; this mitigates the unfairness of including property in a powerholder's estate if the powerholder did not know of or could not exercise the power.

Section 2514 provides that the *exercise* or *release* of a general power of appointment is deemed to be a transfer of the property by the powerholder.

If the power expires by its terms, rather than by an action of the powerholder, then the power is said to *lapse*, and section 2514(e) provides that the lapse of a power during the life of the powerholder is considered a release of the power—and thus a transfer of property—but only to the extent the amount of property subject to the release exceeds the greater of $5,000 and 5% of the aggregate value of the assets out of which the exercise of the lapsed powers could be satisfied. These "5 and 5" powers may lapse every calendar year without transfer tax consequences, thus enabling a donor to give a beneficiary the right to take any amount from a trust, so long as the amount does not exceed 5%, with the right lapsing at the end of the year. All that is included in the beneficiary-powerholder's estate is the amount that could be appointed at the powerholder's death. A right to withdraw 1% - 5% of the trust assets each year (perhaps if the beneficiary is living on the last day of the year) is common, but other creative uses abound; for example, "my spouse may withdraw on the first day of each calendar year an amount equal to the amount my spouse gave to my descendants during the previous calendar year, provided, however, that such amount may not exceed 5% of the fair market value of the trust assets on the first day of such calendar year"). Crummey withdrawal rights are often structured to lapse within the limits of a 5 and 5 power. These are commonly referred to as "hanging" powers, where the withdrawal right exceeds the 5%/$5,000 limit, because, although the right to withdraw is set at a limited period of time (for example, 30 days), the annual exclusion amount is often greater ($15,000 per year for 2019), and if the trust is not well funded the power may continue for several years until the lapse is fully protected by the 5 and 5 exception.

The transfer tax effects of non-general powers of appointment are variable. The exercise or release, itself, of a non-general power has no transfer tax effect. However, if the exercise or release has an effect on the powerholder's other interests in the trust, a transfer tax argument may ensue. For example, suppose a powerholder is entitled to receive all the income from a trust during the powerholder's life and also has a presently exercisable power to appoint the trust property to the powerholder's children. If the appointment of the trust property eliminates the powerholder's income interest and vests the property, and the income, in the powerholder's children, an argument could be made that the powerholder has made a gift..

TAM 9419007 (not precedent) is illustrative. There the grandchild of the creator of the power exercised a non-general power to create new trusts; at the time of exercise, the powerholder had a contingent remainder interest in the trust (which would ripen into absolute ownership of the property upon the powerholder reaching age 30) and the right to receive current trust income until reaching age 30. The exercise of the power terminated those interests. The IRS concluded that the powerholder made a gift, following the Regester case and refusing to follow the Self case, discussed as follows:

> This analysis is supported by the Tax Court decision in Regester v. Commissioner, 83. T.C. 1 (1984). In Regester, the Donor was the income beneficiary of a trust and possessed a limited power of appointment over the trust corpus. The Donor exercised her limited power of appointment, thereupon relinquishing her income interest. The Service asserted that the taxpayer's inter vivos exercise of the limited power of appointment over the corpus of the trust concomitantly effected a gift of her life income interest in the trust. The court agreed with the Service's position. Finding that the taxpayer had made an independent taxable gift of her income interest when she exercised her power of appointment over the corpus, the court stated: When a person has the right to income for life and the ability to transfer that right to anyone or to retain it as long as she lives, transfer of the property without consideration gives rise to a taxable gift. Had [taxpayer] chosen to transfer her life interest to a third party prior to her exercise of the special power of appointment, she would have made a taxable gift of her life interest . . . The fact that she chose to convey that interest to the ultimate owner of the corpus does not disguise the fact that she chose to give her income from the trust property to another without compensation. The transfer of the property should, therefore, be treated as a gift by the life tenant, i.e, [taxpayer], who had an absolute interest in the income. Secs. 2501(a), 2511(a). Such a transfer is taxable irrespective of section 2514.

* * *

The Donor relies on Self v. United States, 142 F. Supp. 939 (Ct. Cl. 1956) to support her position that her relinquishment of the interests on the exercise of the power is not taxable. In Self, the taxpayer was a trust income beneficiary who also possessed a limited power to appoint the underlying trust corpus. The taxpayer exercised the power with the result that his income interest terminated and the trust corpus thereupon passed outright to the appointees. The Service, relying on the regulatory predecessor to section 25.2514-1(b)(2), contended that the taxpayer made a gift of his income interest when he exercised the power of appointment. However, the court held that the taxpayer's power of appointment was a limited power and property (such as the income interest) passing pursuant to the exercise of a limited power is not subject to gift tax. The court found support in Commissioner v. Walston, 168 F.2d 211 (4th Cir. 1948), in which the Fourth Circuit indicated that an income interest relinquished pursuant to the exercise of a limited power of appointment would not be subject to the gift tax. The court specifically disagreed with the regulatory predecessor to section 25.2514-1(b)(2). The Service, in Rev. Rul. 79-327, 1979-2 C.B. 342, announced that it will not follow Self. As discussed below, we believe the continued viability of the Self decision is questionable. Further, we believe the Donor's position conflicts with basic and longstanding estate and gift tax principles. The pivotal question is whether the Donor's characterization of the transfer as the exercise of a limited power of appointment precludes the application of the gift tax to the Donor's transaction. In Helvering v. Clifford, 309 U.S. 331 (1940), Helvering v. Hallock, 309 U.S. 106 (1940), Helvering v. Safe Deposit and Trust Co. of Baltimore, 316 U.S. 56 (1942), and Commissioner v. Church's Estate, 335 U.S. 632 (1949), the Court established the position, for gift tax purposes, that the economic substance of a transfer prevails over the nomenclature given it in the instrument of transfer or state law characterizations of the transaction. *See* Sanford v. Commissioner, 308 U.S. 39 (1939), (stating that the gift and estate tax are in pari materia). Thus, in the present case, the fact that the trust instrument characterized the right granted the Donor as a limited power of appointment and that the Donor chose to dispose of her interests in an instrument labeled "Exercise of Limited Power of Appointment" does not change the substance of the transaction. The Donor was the beneficial owner of the interests, and she transferred them to the Family Trusts. Consequently, for purposes of section 2511, the Donor is regarded as gratuitously transferring her contingent remainder interest and her income interest to the Family Trusts.

After Regester came the Supreme Court's opinion in Jewett that the IRS has concluded rendered Self inapposite. The ruling notes:

> The specific question raised here, whether a contingent remainderman's power of appointment (such as that in the present case) over the contingent remainder interest is a general or limited power of appointment, was addressed by the Supreme Court in Jewett v. Commissioner, 455 U.S. 305, aff'g, 638 F.2d 93 (9th Cir. 1990), aff'g, 70 T.C. 430 (1978). In Jewett, the taxpayer held a contingent remainder interest that would vest on his mother's death if he survived his mother. If he failed to survive his mother, the remainder would pass to his two children. The taxpayer renounced his contingent remainder interest and, under the terms of the trust instrument creating the interest, the interest thereupon passed to his two children. The taxpayer contended that his renunciation was an effective disclaimer for gift tax purposes. In Jewett, the government asserted that the transaction was subject to the gift tax because the taxpayer had not made a timely disclaimer under the applicable regulations. The taxpayer's primary argument was that the disclaimer was timely for federal tax purposes and, therefore, the transaction was not subject to gift tax. This argument, of course, was ultimately rejected by the Supreme Court. However, the taxpayer raised an alternative argument. The taxpayer argued that his disclaimer was tantamount to the exercise of a limited power of appointment over his contingent remainder interest since, under state law, the disclaimer could effectuate a transfer of property to only the limited class of individuals named in the original trust agreement as takers if the taxpayer predeceased termination of the trust. Noting that the exercise of a limited power of appointment is not subject to the gift tax, the taxpayer contended that, even if the disclaimer was not considered timely, the transaction should be recast, instead, as the exercise of a limited power of appointment and, thus, the transfer should not be subject to the gift tax. In response, the government asserted that the power of appointment described by the taxpayer (i.e., a contingent remainderman's power to appoint the contingent remainder in favor of his children) is in the nature of a general power of appointment. Brief for Appellee at 27, 638 F.2d 93 (9th Cir. 1980). The government's brief stated:
>
> Taxpayer is correct in stating that the holder of a limited power of appointment only has the ability to select recipients of the property from among a specified class of donees which does not include himself, his estate, his creditors or the creditors of his estate, and that the exercise . . . of such a power is not taxed as a gift under Section 2514 . . . CLEARLY, HOWEVER, TAXPAYER HERE POSSESSED A SIGNIFICANTLY GREATER POWER over his

future interest; unlike the holder of a limited power of appointment, taxpayer could wait and eventually receive his interest as long as he survived the life tenant, or disclaim and let the interest pass to his children. [Emphasis added.] The Ninth Circuit affirmed the Tax Court's conclusion that the taxpayer had made a taxable gift, but did not address this alternative argument. On appeal to the Supreme Court, the taxpayer again argued that the passage of property as the result of his disclaimer was comparable to the transfer of property pursuant to the exercise of a limited power of appointment, in which the donee of the power can select the recipients of property from a specified class of donees that does not include himself, his estate, his creditors, or the creditors of his estate. Brief for Appellant at 22. Jewett v. Commissioner, 455 U.S. 302 (1982) (No. 80-1614).

In response, the government asserted in its brief: Petitioner . . . pursues his argument that the decision below is inconsistent with estate tax principles by analogizing a disclaimer to a special power of appointment . . . But petitioner's analogy falls wide of the mark. A disclaimant's control over property more closely resembles a general power of appointment, the release of which is a taxable transfer under section 2514 of the Code. A DISCLAIMANT, UNLIKE THE HOLDER OF A SPECIAL POWER OF APPOINTMENT, CAN DECIDE TO ACCEPT THE PROPERTY FOR HIMSELF, IN THE SAME MANNER AS THE HOLDER OF A GENERAL POWER. [Emphasis added.]Brief for Respondent at 34, Jewett v. Commissioner, supra. The taxpayer responded in his reply brief as follows: III. THE COMMISSIONER'S ANALOGY OF JEWETT'S DISCLAIMER TO THE EXERCISE OF A GENERAL POWER OF APPOINTMENT IS INAPT. As Petitioner has argued . . ., if the exercise of a limited power of appointment is not a taxable transfer, then a fortiori a disclaimer, involving a lesser degree of control, should not be taxable . . . It is the Commissioner's analogy which fails. Reply brief for Appellant at 3, Jewett v. Commissioner, supra.

Thus, in Jewett, the question of the nature of a power of appointment (characterized as a limited power) held by a contingent remainderman over his contingent remainder interest was fully briefed for consideration by the Ninth Circuit and the Supreme Court. Although the Ninth Circuit did not directly respond, the Supreme Court considered the question and agreed with the government's position, stating: [P]etitioner argues that the disclaimer of a contingent remainder is not a taxable event by analogizing it to an exercise of a special power of appointment, which generally is not considered a taxable transfer. 26 U.S.C. section 2514. As the Commissioner notes in response, however, a disclaimant's control over property more closely resembles a GENERAL power of appointment, the exercise of which is a taxable transfer . . . Unlike the holder of a special power -- but like the holder of a general power -- a disclaimant may decide to retain the interest himself. 455 U.S. at 317-318. The interests and powers held by the Donor in the present case are identical to those possessed by the taxpayer in Jewett. That is, just as in Jewett, had the Donor in the present case failed to exercise her power, she would have continued to hold the contingent remainder subject to the power until receiving the trust property outright at age 30. In addition, she would have continued to receive the trust income (subject to the power) until reaching age 30. Thus, just as in Jewett, the Donor, as the contingent remainderman and income beneficiary, could at all times have appointed the interests subject to the power to herself by simply not exercising the power. The statement in the trust instrument that the power could not be exercised in favor of the holder of the power was clearly a meaningless limitation, in view of the trust terms. Therefore, the Court's conclusion in Jewett, that the power held by the taxpayer was a general power of appointment, rather than a limited power, controls in this case as well. Consequently, the power of appointment held by the Donor in the present case is properly characterized as a general power of appointment within the meaning of section 2514(c). Thus, for purposes of section 2514, the Donor exercised a general power of appointment and made a taxable gift when she executed the instrument entitled "Exercise of Limited Power of Appointment" transferring the contingent remainder and income interests to the Family Trusts.

THE PRECEDENTIAL VALUE OF SELF The Donor anticipates commencing a refund action in the Court of Federal Claims and opines that the Court of Claims' decision in Self would constitute binding precedent in the Court of Federal Claims as well as the Federal Circuit. We do not agree with the Donor's assertion that, if the Court of Federal Claims and the Federal Circuit were to consider the issue today, Self would be followed by those courts. We believe that the conclusion of Jewett, that the taxpayer's transfer, even if characterized as the exercise of a power of appointment, would be subject to gift tax, effectively overrules Self. The Donor argues that the Supreme Court's characterization of the taxpayer's interest in Jewett as a general power of appointment was dictum. We disagree. As demonstrated above, the taxpayer raised this issue as an alternative ground for relief. That is, the taxpayer was arguing that, even if the disclaimer was not timely for federal gift tax purposes, nonetheless, the taxpayer did not make a taxable gift because the transfer was made pursuant to the exercise of a limited power of appointment. The issue was fully briefed by

> both parties in the Ninth Circuit and again in the Supreme Court. Thus, the Supreme Court was rendering a decision on an issue specifically raised by the taxpayer on several occasions and one which, if decided in the taxpayer's favor, would relieve the taxpayer from any gift tax liability. The Court's ruling on this issue can hardly be characterized as gratuitous or not essential to the determination of the taxpayer's gift tax liability.

For purposes of section 2042, a power of appointment will be an incident of ownership over a life insurance policy. *See* PLR 201327010 (not precedent).

There are income tax consequences to powerholders. Section 678(a)(1) provides that a powerholder will be treated as the owner for income tax purposes of any portion of a trust from which the powerholder has the power, exercisable by herself, to vest the corpus or income in herself unless the grantor of the trust is treated as the owner for income tax purposes. If a power is released or modified, whether the powerholder is treated as the owner of the portion over which the power existed depends on whether the powerholder would have been treated as the owner of the trust were the powerholder the grantor of the trust. An exception is that a powerholder may have the power as fiduciary to direct the trust income to the support and maintenance of a person to whom the powerholder has a support obligation without income tax consequence except to the extent the income is actually distributed to satisfy this obligation.

There are also income tax consequences to those who receive assets either by the exercise of a general power of appointment or the takers in default if a general power is not exercised. Section 1014(b)(9) provides that property required to be included in a powerholder's estate by reason of a power of appointment will be deemed to have been acquired from the decedent powerholder and thus under section 1014(a) will have, in the hands of the recipients, basis equal to the fair market value of the property at the decedent's death (with well-known exceptions for certain kinds of property, including income in respect of a decedent described in section 691 (IRD) property, and property acquired by the powerholder by gift from the recipient within one year of the powerholder's death (section 1014(e)).

General powers of appointment may arise in unexpected circumstances. For instance, a small trust termination provision may be a general power if the trustee is a potential beneficiary. *See* PLR 9840020. In TAM 8330004 the ability to purchase trust property at below fair market value was a general power.

D. <u>Exercising a Power to Create a Power: Taxation, and the Delaware Tax Trap.</u>

In many instances, a powerholder may exercise the power to create a new power of appointment. *See,* e.g., Uniform Act § 305. If the first power is a general power and the exercise occurs by will, the appointive assets will be subject to federal estate taxation. *See* IRC § 2041(a), (b). If the first power is a general power and the exercise occurs inter vivos, the exercise "shall be deemed a transfer" for federal gift tax purposes. IRC § 2514(a), (b).

If the first power is a non-general power, the exercise (to create a new power) will have tax consequences only if the "Delaware Tax Trap" provisions of IRC § 2041(a)(3) or § 2514(d) are satisfied. As summarized by Jonathan Blattmachr & Jeffrey Pennell, *Adventures in Generation-*

Skipping, or How We Learned *to Love the Delaware Tax Trap*, 24 REAL PROP., PROB. & TR. J. 75, 82 (Spring 1989):

> These arcane and little known sections provide that property subject to a non-general power of appointment will be includible in the estate of the powerholding beneficiary (or will be subject to gift tax upon exercise) to the extent the power is exercised to create another power of appointment that "can be validly exercised so as to postpone the vesting of any estate or interest in [the] property, or suspend the absolute ownership or power of alienation of [the] property, for a period ascertainable without regard to the date of creation of the first power." In more simple terms, exercise of a non-general power of appointment to create a new power of appointment that has the effect of postponing the period of the Rule Against Perpetuities converts the non-general power of appointment into a taxable power for purposes of sections 2041 and 2514.

The reason why these IRC provisions are known as the "Delaware Tax Trap" is that the provisions, enacted in 1951, responded to an unusual feature of Delaware law. Under the traditional perpetuities law of most states, the exercise of a non-general power to create a new non-general power would not extend the period of the Rule Against Perpetuities. In other words, the exercise of the second non-general power would "relate back" for perpetuities purposes, meaning that for perpetuities purposes the exercise by the second powerholder would be treated as an exercise by the first powerholder. Delaware law (Del. Code tit. 25 § 501), however, provides that the exercise of a power of appointment — even a non-general power — changes the "time of creation" for perpetuities purposes; the perpetuities clock begins running anew from the time of the power's exercise. This has the effect of allowing the successive exercise of non-general powers to frustrate the goals of the Rule Against Perpetuities and allow property to pass along successive generations without estate tax (query whether transactions that do not create that result could be argued not to spring the trap). In response, Congress enacted §§ 2041(a)(3) and 2514(d).

After the advent of the generation-skipping transfer tax, some commentators (including Blattmachr and Pennell) observed the potential planning benefits of the Delaware Tax Trap. Depending on the facts of a particular case, it may be more advantageous to trigger estate or gift tax liability rather than generation-skipping transfer tax liability. One way to trigger estate or gift tax liability is to "spring" the Delaware Tax Trap: to have the powerholder of a non-general power exercise that power to create a new power so as to extend the period of the Rule Against Perpetuities. As Blattmachr and Pennell observed (24 REAL PROP., PROB. & TR. J. at 75):

> Best of all, under the Delaware Tax Trap, it is the powerholding beneficiary, not the trustee or some third party, who decides which tax will apply. Indeed, even if the non-general power were granted in the first instance only in the trustee's discretion, it will still be the powerholding beneficiary who ultimately makes the decision whether to expose trust assets to estate or gift tax rather than generation-skipping transfer tax, and to what extent.

> … The tax to be incurred is totally within the discretion of the powerholding beneficiary who, presumably, is best able to judge whether to incur estate or gift tax and who, presumably, cannot be sued for the consequences of exercising (or failing to exercise) the power.

Whether the exercise of a non-general power to create a new power does or does not trigger the Delaware Tax Trap depends on whether, under the particular state's perpetuities law, the second power "can be validly exercised so as to postpone the vesting of any estate or interest in the property which was subject to the first power, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power." IRC §§ 2041(a)(3), 2514(d). The answer to this question depends on a careful reading of the relevant state's perpetuities law, and on this even experts disagree. As Professor Lynn Foster accurately noted in her article *Fifty-One Flowers: Current Perpetuities Law in the States*, PROB. & PROP. 30, 33 (July/Aug. 2008), "there is little agreement or certainty in this area of the law." Examining perpetual-trust statutes enacted before 2002, Professors Jesse Dukeminier and James Krier concluded that trusts in Arizona, Delaware, Illinois, Maine, Maryland, Missouri, Nebraska, Ohio, Rhode Island, and Virginia were still subject to the Delaware Tax Trap, while the same year attorney Julia Fisher concluded that the Delaware Tax Trap applied to perpetual trusts only in Arizona, Colorado, Delaware, Idaho, Rhode Island, and Virginia. (For citations, see Foster at 33.) Ultimately, a careful review of each state's perpetuity law is required. That, however, is beyond the scope of these materials.

Perhaps, all that can be usefully noted for present purposes is that some perpetual-trust jurisdictions have responded to the Delaware Tax Trap by enacting statutes providing that the exercise of a second non-general power will be measured from the creation of the original non-general power. *See* Alexander A. Bove, Jr., *Using the Power of Appointment to Protect Assets — More Power Than You Ever Imagined*, 36 ACTEC J. 333, 354 (2010) (citing Alaska Stat. § 34.27.051 and Del. Code tit. 25, §504).

II. <u>Common Uses of Powers Of Appointment</u>

A. <u>Second Look Changes.</u>

An important use of powers of appointment is to allow changes to be made in trust provisions after the trust was created. The powerholder may be able to appoint the assets of a trust to an entirely new trust with different administrative provisions (e.g., governing law; situs; or the spendthrift or investment provisions or provisions for investment or distribution committees that advise or direct the trustee) or dispositive provisions (e.g., removing existing beneficiaries and adding new ones, or changing the terms under which income and principal may be distributed to one or more beneficiaries). Many decanting statutes do not allow trustees to change the dispositive provisions of a trust but do allow the creation of powers of appointment which the powerholder may then use to change the trust's dispositive provisions.

With the repeal or extension of the rule against perpetuities in many states, and the ability of grantors to create trusts invoking the law of those states, there has been much discussion of ever-lengthening trust terms or even so-called perpetual trusts. Perpetual charitable trusts have been allowed for hundreds of years, yet only a few last for longer than a century; so the viability of multi-century or longer trusts may be questioned. These long-term or perpetual trusts have been attacked on the ground that the number of beneficiaries will outstrip the ability of any trustee to manage the trust and that the trust will become outdated. *See,* e.g., *From Here to Eternity: The Folly of Perpetual Trusts*, Univ. of Michigan Public Law Working Paper, no. 259. Working Paper by the distinguished professor and long-time leader in the trusts and estates field, Lawrence W. Waggoner of the University of Michigan; and Immortality and the Law: The Rising Power of the American Dead (Yale University Press, 2010) by Ray D. Madoff, a thoughtful professor at Boston College Law School. Powers of appointment are the answer to much of the criticism. With powers of appointment, a trust may be kept up to date—"evergreen" as it is sometimes called—at every generation. There may be other policy reasons why long-term or perpetual trusts should be disfavored but that is outside the topic of these materials.

1. Powers to Appoint are Powers to Disappoint.

Many grantors want to give a senior generation almost, but not quite, unfettered access to trust assets (to coin a phrase, "lightly-fettered" access). For example, the grantor may want the surviving spouse as trust beneficiary to be untroubled by the complaints of the children or grandchildren that the surviving spouse's lifestyle is too expensive, yet do not want the surviving spouse to be able to divert assets to a new spouse or companion or discover a newfound love of the opera or the Little Church of the Misdirected Vision. These concerns may also extend to trusts for children when assets are to remain in trust for grandchildren. A common response to this concern is to allow the senior beneficiary to appoint the trust assets at death among the junior beneficiaries, but to be able to pick and choose among them. For example, a child is less likely to nitpick a surviving spouse when the surviving spouse could decide that the child's siblings are more desirable beneficiaries. The theory is that the trustee will prevent the spouse from doing anything "crazy," and the power of appointment will prevent the children from discussing whether mother should have a Camry or a Lexus.

A collateral concern may be for senior beneficiaries who believe that the junior generation pays positive attention to them only for the money. Thus, if the surviving spouse cannot divert the bulk of the assets away from the children and grandchildren, will the children and grandchildren visit and care for the surviving spouse? The ability of the surviving spouse to skip the children and distribute everything to the grandchildren may be a powerful inducement for the children to remind the parent of their love and affection, although such moments may be best suited for the stage. Here the balance is delicate. Regardless of good intentions and efforts by children, some parents are spiteful and, given the opportunity to "punish" children by skipping them, may do so gleefully; indeed, some couples are concerned that if a surviving spouse lives long enough, irrational behavior like this may result. (The rubric "a power of appointment can also be a power of disappointment" is originally attributed to Professor Ed Halbach.)

2. Powers Granted for Transfer Tax and Income Tax Purposes.

a. General Powers and Estate Tax Inclusion.

General powers are necessary to achieve certain tax results, one being a general power of appointment marital trust as described in section 2056(b)(5) and another being the qualification as a gift that would otherwise be a future interest (a gift to a Crummey trust, for example) for the annual exclusion (the right to withdraw is a presently exercisable general power of appointment).

i. Powers of Appointment and the Marital Deduction

Property transferred whereby a property owner provides his or her spouse with an income interest for life, coupled with a general power of appointment exercisable in favor of the property owner's spouse or the spouse's estate (but not merely to her creditors or those of her estate), may qualify the property for the estate or gift tax marital deduction under sections 2056(b)(5) or 2523(e). Property transferred under which a property owner provides his or her spouse with an income interest for life may qualify the property for the estate or gift tax marital deduction by election as qualified terminable interest property ("QTIP") but only if, among other conditions, no one has a lifetime power of appointment other than one exercisable exclusively to the spouse.

Under section 2523(b)(2), a transfer will not qualify for the gift tax marital deduction if the donor, immediately after the transfer, has a power to appoint an interest in the property which the donor can exercise (either alone or in conjunction with any person) in such manner that the appointee may possess or enjoy any part of such property after the termination of the interest transferred to the donee spouse. For purposes of this provision, the donor is considered to retain such a power after the transfer to the donee spouse, even if it cannot be exercised until after a period of time, upon the occurrence of an event or contingency, or upon the failure of an event or contingency to occur.

This odd provision has been in the Code since the enactment of the marital deduction in 1948. (For a detailed discussion of the provision, see Blattmachr, Zeydel & Gans, ""World's Greatest Gift Tax Mystery Solved," 115 Tax Notes 243 (April 16, 2007) It appears, on its face, that, if a wife creates a QTIP trust for her husband and she retains a power of appointment (even a non-general power) exercisable after her husband's death, the transfer fails to qualify for the marital deduction even though the terms otherwise are as required under section 2523(f) of the Code and no one else can enjoy the property until after the husband has died. However, there are two statements in the legislative history to the Economic Recovery Tax Act of 1981, under which QTIPs were first allowed to qualify for the marital deduction, providing that the spouse who creates a QTIP trust may retain a power to control disposition of the property after the spouse for whom the trust was created dies, as well as at least one private ruling from the IRS to the same effect.

To reconcile this conflict, remember that a power of appointment the grantor creates for himself or herself is not considered a power of appointment for federal gift tax purposes (although it is such a power for property law purposes). Rather, it is treated as a power to control the beneficial enjoyment of the property, usually triggering estate tax inclusion under section 2036(a)(2) of the Code. Hence, section 2523(b)(2) of the Code would apply only where the spouse making the transfer to a QTIP trust holds a power of appointment granted by someone else, such as his or her parent. Apparently, the drafters of the 1948 Act felt a special rule was required to cover such powers of appointment because of the understanding, mentioned above, that a power of appointment is something other than an interest in property.

ii. Generation-Skipping Transfers and General Inclusion to Acquire Basis

General powers of appointment are also used to ensure that assets in trust are included in a powerholder's estate, which has the effect of preventing a generation-skipping transfer, and to achieve a new basis at the powerholder's death. Each of these is discussed below.

Contingent general powers are often inserted into instruments for the purpose of including trust assets in a beneficiary's estate rather than subjecting those assets to the generation-skipping transfer tax. The theory behind the use of such a power is often that the trust beneficiary may use the power to mitigate the effects of the GST tax through a marital or charitable disposition, or may have exclusion available to shelter the assets subject to the power from the estate tax. Careful drafting is required to accomplish the result intended. For example, a power that applies to all trust assets whenever those assets would otherwise be subject to the GST tax could successfully avoid a small GST tax at the cost of a large estate tax imposed on the beneficiary's estate. A better method is typically to trigger the contingent general power only when, or to the extent, doing so will produce less GST tax than the combined federal and state estate tax (determined as if the power is not exercised) otherwise resulting, but such a formula is subject to the same sort of criticism noted above because the application of the formula may depend on whether the beneficiary's estate obtains a marital or charitable deduction, and also any possible creditors of the powerholder.

Basis planning has become significantly more popular with the increase in the federal estate tax exclusion amount. In many situations, trust beneficiaries do not have taxable estates, hence the inclusion of assets in a beneficiary's estate by decanting or amending the trust to make the beneficiary a powerholder of a general power will generate a free basis increase.

Powers may be drafted to accomplish the tax savings with precision if the facts likely to be present are reasonably well known. For example, a power may encompass only assets that have a fair market value higher than basis, so that in a portfolio where some assets have increased and others decreased only those whose basis would be increased may be subject to the general power. Further, the maximum amount subject to the power could be capped so that the powerholder is not subject to estate tax. Care must be taken to ensure that the amount subject to the power is ascertainable at the powerholder's death; in general, a cap that references the basic exclusion amount (or in appropriate cases the applicable exclusion amount) will be safer than a cap tied to whether federal estate tax is paid; that is, a formula that does not depend on the presence of marital and charitable deductions. The IRS's argument might be that, despite the crux of the Fifth Circuit's ruling in Clayton v. Commissioner that a QTIP election relates back to the date of death (and the same could be said about qualified disclaimers), these actions do not relate to a general power of appointment under section 2041 of the Code. The election and disclaimer do, however, affect the value of property subject to the general power of appointment. As such, they are similar to a contingency that has not yet occurred on the date of death. In PLR 8516011, the IRS ruled that a marital bequest conditioned on the spouse's survival of the decedent's will being admitted to probate would not be included in the spouse's estate because the spouse died prior to that event. In the ruling, the IRS stated that even though the spouse had the power to admit the will to probate and thus had a power of appointment, this power of appointment was subject to the formal admission to probate, which in turn required a substantive determination by the court regarding the validity of the will. As such, the general power of appointment was deemed not to exist for estate tax purposes.

Adjustments to consider state tax regimes may also be included in the formula if desirable.

iii. Circumscribed General Power

Consideration may be given to using for basis purposes what may be called a "Circumscribed General Power." Such a power would have these characteristics: (1) it is a testamentary power; (2) only to the creditors of the powerholder's estate; (3) exercisable only with the consent of a non-adverse individual; (4) over assets that have a fair market value at death in excess of basis; (5) in a total amount that, when added to all other assets included in the powerholder's gross estate for federal estate tax purposes and prior adjusted taxable gifts, does not exceed the powerholder's Basic Exclusion Amount less $1000. The purpose of the first two characteristics is to make the power as limited as possible. The purpose of the third is to prevent accidental and unintended exercises. The purpose of the fourth is to avoid a step-down in basis. The purpose of the fifth is to ensure that the existence of the power does not generate any federal estate tax or cause the filing of an otherwise unnecessary federal estate tax return that the IRS cannot argue that the amount of the power was fixed at death. If the formula power depends on the disposition of the powerholder's estate, for instance whether there is a charitable deduction, or on expenses in the estate, then there appears to be a risk that the IRS could argue the amount subject to the power is not determinable at the moment of death. The Applicable Exclusion Amount could be substituted for the Basic Exclusion Amount if that is applicable. Where the power potentially extends to more assets than will be allowed because of the maximum limitation in (5), then a trust director of some sort may be authorized to determine the assets subject to the power. For maximum safety, the trust director should be able to direct the trustee on that point at any time prior to the powerholder's death, but not afterwards.

All specific assets within a trust should be subject to the general power, those assets may be contributed by trustee to an LLC. The LLC may be a disregarded entity so long as it exists under state law.

iv. The Special Case of Adding a General Power in the Grantor to a Trust Created by the Grantor.

Treas. Reg. § 20.2041-1(a)(2) provides that the term "power of appointment" does not include powers reserved to the decedent within sections 2036 to 2038. Section 2038 applies to such a power as long as it is held by the grantor on the date of (or was released within three years of) the date of death without regard to when or from what source the grantor/decedent acquired such power. So, in principle, giving the grantor such a power (by trust amendment, decanting, etc.) will cause estate tax inclusion. However, the Skifter line of cases confuses this simple reading. Under that line of cases, section 2038 will only apply if the power was reasonably anticipated by the grantor when the trust was created.

In Estate of Skifter v. Comm'r, 468 F.2d 699 (2d Cir. 1972), *aff'g* 56 T.C. 1190 (1971), *nonacq. recommended* AOD (Dec. 22, 1971), *acq*. 1978-2 C.B. 1, decedent gave his wife an insurance policy on his own life. Within three years his wife died and left the policy to a trust of which the insured/decedent was trustee; as trustee, he could change the policy beneficiaries. The

Tax Court and the Second Circuit both held that despite the incidents of ownership the insured's estate should not be taxed under section 2042 because section 2042 should be applied like sections 2036 and 2038 are. Because the insured/decedent had acquired that incident of ownership from an unexpected, uncontrolled source, it was not a "retained" power. In Hunter v. United States, 474 F.Supp. 763, 764-65 (W.D.Mo.1979), *aff'd*, 624 F.2d 833 (8th Cir. 1980 and Estate of Fruehauf v. Comm'r,427 F.2d 80 (6th Cir. 1970), the Eighth and Sixth Circuit followed Skifter. But, the Fifth Circuit, has not but the rejection was grounded in a belief that section 2038 was not relevant to interpreting section 2042 and life insurance inclusion. Terriberry v. United States, 517 F.2d 286 (5th Cir. 1975), *cert. denied*, 424 U.S. 977 (1976); and Rose v. United States, 511 F.2d 259 (5th Cir. 1975).

More generally, in Estate of Reed v. U.S., 36 AFTR 75-6413 (S.D. Fl. 1974), the court noted that section 2038 applied only where whatever caused the transferor/decedent to have the powers subsequently were originally set in motion by the transferor/decedent. The IRS non-acquiesced in Skifter, but then adopted its analysis in Rev. Rul. 84-179 in which it excluded the proceeds of a life insurance policy from an insured decedent's gross estate, if the policy was held in a fiduciary capacity, the incidents could not be exercised for the decedent's personal benefit, the decedent didn't fund the trust, and the "devolution of the powers on decedent was not part of a prearranged plan involving the participation of the decedent."

b. Non-general Powers and Incomplete Gifts.

Non-general powers of appointment have an important tax use in making gifts to trusts incomplete. Incomplete gifts may be helpful for many purposes but a common one is the transfer of assets to a trust that is not a grantor trust for income tax purposes. If the grantor is domiciled in a high income-tax state, and the transfer can be made to a trust that will be taxed in a lower tax state—for example, a state that does not tax assets in trusts created by non-domiciliaries—then overall income tax savings will be achieved if there is no imposition of gift tax. In order to avoid gift tax, the grantor must retain a lifetime and testamentary power of appointment and the powers of appointment must be sufficiently limited to avoid the grantor trust rules of §§ 671–677. Further discussion of this issue is beyond the scope of these materials, but private letter rulings tracing the history of the IRS position include PLR 200148028, PLR 200715005, CCA 201208026, 20131002, and 201426014.

c. Avoiding Reciprocal Trusts

When two taxpayers create "reciprocal" trusts for each other, those trusts will be "uncrossed" for tax purposes so each taxpayer is treated as creating the trust for his or her own benefit for certain federal tax purposes. Among other things, this can cause the property in the trusts to be included in the gross estate of the beneficiary even though, in fact, he or she did not create it. *See,* e.g., Grace v. United States, 395 U.S. 316 (1969). However, in Levy v. CIR, TC Memo 1983-453, the United States Tax Court found the reciprocal trust doctrine did not apply to the assets in the trust Mr. Levy's wife created for him, only because he had granted her a broad lifetime non-general power of appointment over the trust he created for her, and she did not grant him such a power in the trust she created for him. Granting a lifetime special power to the beneficiary of one trust but not the other when the trusts might otherwise might be considered reciprocal may prevent the doctrine from applying, especially if combined with other differences (such as different distribution standards and abilities to remove and replace trustees). Note, of course, that Levy was only a Tax Court Memorandum opinion.

3. Powers as Trustee Substitutes.

Powers of appointment may also substitute for the power of a trustee to make trust distributions, and a distribution pursuant to such exercise is generally treated in the same manner as a fiduciary directed distribution although the IRS position is not entirely certain. For example, PLR 201225004 involved a trust claiming the section 642(c) deduction for income distributed to charity and the requirement that the income be distributed "pursuant to the terms of the governing instrument." The distribution was directed by a beneficiary's exercise of a lifetime special power of appointment which the IRS determined had satisfied the "pursuant to" requirement even though the governing instrument did not specify a charitable bequest. It only authorized exercise of the power in favor of charity.

> Special Risk With Powers of Appointment Exercisable During Lifetime.
>
> If a living settlor, or a current beneficiary, has significant influence over the powerholder, tax issues may result. In the 1970s two cases dealing with the Goodwyn family established the principle that if a trust agreement prohibited the grantor from acting as de facto trustee the mere fact that the grantor did in fact act as de facto trustee would not establish a retained interest under section 2036, Estate of Goodwyn, T. C. Memo. 1973-153, nor a power for the grantor trust provisions of sections 671 et. seq., Estate of Goodwyn v. Commissioner, T.C. Memo. 1976-238.
>
> A powerholder is (usually) not a fiduciary and thus the Goodwyn rationales do not apply. *See* also Securities and Exchange Commission v. Wyly, 2014 WL 4792229 (S.D.N.Y. Sept. 25, 2014) which ignored what the court concluded were fiduciary duties in name only.

4. Power of Appointment Not Subject to Fiduciary Standard.

In In re Estate of Zucker, 2015 WL 5254061 (Pa. Superior Ct. 2015), decedent's wife, Syma, exercised a power of appointment in favor of two of three children. The third, Wendy, objected:

> Wendy alleged that Syma's appointment was not a proper exercise of the power as it was done "in bad faith, based on hate and malice toward Wendy, contrary to [the Decedent's] intent to benefit his issue equally (absent a good faith reason to the contrary) and the duty imposed on Syma to act in good faith when exercising a testamentary power imposed by Pennsylvania law."

The court disagreed, declining even to impose a good faith standard. The opinion states:

> We have reviewed the language contained in Decedent's will and in the codicil to Syma's will in which she directed that the principal contained in the marital trust be divided into two trusts for the benefit of Scott and Karyn and their issue. We have also

> reviewed the case law provided by the parties and the orphans' court. We conclude that none of the cases, in which challenges to the exercise of the power of appointment were raised, direct that the appointments must be made in good faith. Rather, we state again that a donee's duty is to the donor and the donee must exercise that power within the donor's established conditions. Moreover, the donee has the right to select some of the potential appointees to the exclusion of others. *See* Estate of Kohler, 344 A.2d at 472. No duty of good faith has been established. Therefore, we conclude that the orphans' court's grant of Scott and Karyn's motion for judgment on the pleadings was proper. The orphans' court did not commit an error of law.

The court notes that Syma was not the trustee. Does that matter? Suppose she had been; her exercise of a testamentary power of appointment would seem to occur after service as trustee ended. May a trustee exercise an inter vivos power without following a fiduciary standard?

5. <u>May The Same Person Simultaneously Be a Trustee and a Powerholder?</u>

A trustee has a fiduciary duty to all trust beneficiaries. May a trustee alter a trust using a power of appointment if to do so affects different beneficiaries differently? For example, suppose a surviving spouse is the trustee of a trust for the couple’s descendants, and may also be a beneficiary, while holding an inter vivos power of appointment that allows the surviving spouse to increase or reduce the shares of those descendants and/or the terms on which the shares are distributed or administered. May the surviving spouse exercise that power of appointment while serving as trustee? Presumably a testamentary power does not raise this question because the surviving spouse would have ceased being trustee at the moment of death. There is no clear authority on the point.

The California Court of Appeals held in <u>Tubbs v. Berkowitz</u>, 47 Cal.App.5th 548 (Cal.App. 2020), that where a surviving spouse is named both as trustee of a marital trust and is given a lifetime general power of appointment over the marital trust assets, the surviving spouse could exercise the nonfiduciary power of appointment even while serving as trustee. The opinion states:

> A trustee “has a duty to administer the trust according to the trust instrument ....” (§ 16000.) A trustee also only has the powers conferred by the trust instrument and the powers conferred by statute, unless limited by the trust instrument. (§ 16200.) Here, the very language of the Marital Trust allowed Berkowitz to act in his capacity as the surviving spouse (not the trustee) and designate himself as the recipient of the Trust assets. The Marital Trust then required the trustee to distribute the assets to any person designated by the surviving spouse, including the surviving spouse himself. Thus, under the plain terms of the Marital Trust, Berkowitz (acting as the trustee) was required to transfer the assets once he exercised the power of appointment in his favor. He could not possibly have breached

> any fiduciary duties by doing something that was expressly authorized and required under the terms of the Marital Trust. (*Hearst v. Ganzi* (2006) 145 Cal.App.4th 1195, 1207-1208, 52 Cal.Rptr.3d 473 [trustees did not breach their fiduciary duties where their actions were explicitly authorized by the trust].)
>
> Finally, we note that Berkowitz's exercise of his power of appointment would have been unobjectionable if he had resigned as trustee before exercising the power. In that scenario, the successor trustee (Tubbs) would have been required to transfer the assets to Berkowitz once he exercised the power of appointment in his favor. Tubbs claims "those are not the facts before this Court," but we see no reason why the result should be different where Berkowitz was both the donee and the trustee who had no discretion but to follow the terms of the power of appointment.

No authority is cited on the point (either way).

To the contrary is Peterson v. Peterson, 835 S.E.2d 651 (Ga. App. 2019), a much litigated matter whose facts were described as follows:

> Charles Hugh Peterson died testate in 1994 and was survived by his wife, Mary, and their three sons Alex, David, and Calhoun. Mr. Peterson's will, which was probated in 1995, created two testamentary trusts: a marital trust for the primary benefit of Mary, and a residual "by-pass" trust for the benefit of Mary and the couple's three sons. Mary and her three sons were each designated a co-executor of the will and a co-trustee of both the marital and by-pass trusts. Item 5 of Mr. Peterson's will created a marital trust for Mary, while Item 6 created a by-pass trust for Mary and their three sons. The relevant portion of the will creating the terms of the by-pass trust reads as follows:
>
>> Trustees shall hold and manage the property in this trust and ... may encroach on such part of the principal thereof as the Trustees may deem necessary to provide for the support in reasonable comfort of my wife and to provide for the proper support and education of my descendants[.] To the extent practicable, however, I request the Trustees in making encroachment for the benefit of my wife to encroach first on any trust created for my wife ... before encroaching on this trust for my wife[.]
>>
>> My primary desire is that my wife be supported in reasonable comfort during her lifetime and that my children be supported in reasonable comfort during their

> lives; my secondary desire is that the principal of this trust be preserved as well as possible consonant with the consummation of my primary objective[.]
>
> [My wife] shall have no power to appoint [trust] property to herself, to her estate, to her creditors, or to the creditors of her estate.
>
> * * *
>
> Sometime after the will was probated, a dispute arose between the co-executors and co-trustees over the administration of the estate and the by-pass trust, pitting Mary and Calhoun against Alex and David. Alex and David filed petitions for accounting and damages for breach of duties as executors and trustees against Mary and Calhoun, and sought the removal of Mary and Calhoun as executors and trustees in probate court. Mary and Calhoun each moved for summary judgment on all claims, and the superior court granted their motions. Alex and David appealed those rulings.
>
> In the first appearance of this case before this Court, we reversed the trial court's grant of summary judgment to Calhoun in an unpublished opinion. See *Peterson I*. One month later, the Supreme Court of Georgia in *Peterson II* reversed the trial court's grant of summary judgment to Mary for similar reasons. Both cases held that material issues of fact remained with respect to Appellees' failure to fully fund the trusts at issue in the case and whether Appellees wasted assets. See *Peterson I*, slip op. at pp. 7-8, 10; *Peterson II*, 303 Ga. at 215-217 (3), 811 S.E.2d 309.

The trial court had held that Mary did not owe the other beneficiaries a fiduciary duty when exercising the power of appointment. Mary cited a Connecticut case, <u>Connecticut Bank & Trust Co. v. Lyman</u>, 170 A.2d 130 (Conn. 1961) but the Georgia court noted in <u>Lyman</u> the powerholder was not a trustee. The Georgia Court of Appeals went the other way, deciding Mary <u>did</u> have a fiduciary duty:

> In the present case, the potentiality of conflicts of interests with respect to Mary's requests for conveyance of all property in the by-pass trust to Calhoun is well documented in the litany of litigation that has transcended decades among the co-trustees and co-beneficiaries. As we find no law which could excuse Mary from her fiduciary duty under the trust, even if acting solely as a beneficiary under the trust, we find that the trial court erred in concluding that Mary could act exclusively in her capacity as a beneficiary of both trusts in exercising her appointment power to convey trust assets.

Presumably the exercise of a power of appointment by a trustee to alter administrative provisions might not pose the issue, at least if the change did not benefit the trustee in some manner. For instance, a change of jurisdiction or law applicable to a trust might be permitted if it were clearly for the benefit of the beneficiaries but there could be a different result if the change raised the trustee's standard of liability. In general, other persons involved in trusts are fiduciaries, by whatever name – advisors, trust protectors, distribution or investment committees, what the Uniform Directed Trust Act refers to as "trust directors" – each of whom might be subject to this same analysis. Prudence suggests having a fiduciary resign as such before the exercise of a power, even if reappointed later (the key being to ensure that under applicable state law a court would not conclude that the steps of resignation, exercise of the power, and reappointment, were so integrated that the fiduciary duty persisted). Although the circumstances are unlikely to occur, note that a power to substitute assets under section 675(4)(C), which must be a non-fiduciary power in order to produce grantor trust status, is a power of appointment and should not be held by someone who is also serving in a fiduciary capacity.

III. <u>Upstream Sale to a Power of Appointment Trust (UPSPAT)</u>

A. <u>Generally.</u>

Suppose a child creates a grantor trust, sells assets to the trust for a note, gives the child's parent a testamentary general power of appointment over the trust assets so that the assets will be included in the parent's estate at the parent's death and receive new basis, and then the trust (which remains a grantor trust with respect to the child even after the parent's death) uses the assets to pay off the note. The net effect is that the parent's net estate is increased by zero or a small amount yet the child receives new basis.

Because the contemplated transaction is not designed to remove assets from the child's estate for estate tax purposes, the section 2036 issues that require that the grantor trust be seeded would not apply. However, a sale to an unseeded trust could result in a note having a value less than its stated face value, thus causing child to make a gift. A note has a limited upside – the amount of interest due – but a potential for the principal to decline to zero. Most assets that will be sold to the UPSPAT have the potential of a decline to zero, but have more upside than the amount of interest due on the note. Although that difference may be difficult to determine, and will vary in magnitude, in many instances as a matter of principle it will be true that the note will have a lower fair market value. A seeded trust reduces the potential of a decline to zero; even if the asset sold declines in value to zero the note may have some value. Similarly, parent's guarantee of the note could reduce that risk if the parent's assets are commensurate with the amount of the note.

Does the existence of the parent's general power cause the assets to be stepped up to full fair market value, or will the value of the note reduce the amount of the step-up? Section 2053(a)(4) provides that the value of the taxable estate will be reduced by indebtedness in respect of property included in a decedent's estate. Treas. Reg. § 20.2053-7 provides in relevant part:

> A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the

> value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be retuned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth.

Thus the net increase to parent's estate would seem to be zero. If parent guaranteed the obligation then this concern would be reduced. Arguably such a step is unnecessary because the regulations may be read as discretionary or optional. Further, outside the trust context, Crane v. CIR, 331 US 1 (1947) suggests that the basis increase is based on the fair market value of the property regardless of the associated debt.

In thinking about this issue, consider a QTIP or general power of appointment marital trust with $3,000,000 in non-dividend paying Berkshire-Hathaway stock as assets. Suppose the trust borrows $100,000 and distributes the cash to spouse because spouse is not receiving any dividends. This might be an alternative to selling $100,000 worth of stock and incurring gain. At spouse's death the trust is worth $2,900,000 -- $3,000,000 less the $100,000 loan. Spouse is not personally liable for the $100,000 loan. Does the Berkshire-Hathaway stock receive a basis, in total, of $3,000,000 or $2,900,000? On the other hand, consider the child's grantor trust. Suppose parent actually appointed the assets to the parent's estate. Now the parent's estate has the trust assets, and the trust continues to owe the debt. If the debt is severable from the assets, has child made a gift when the general power springs into existence? Again, the parent's guarantee is helpful.

Subject to the considerations discussed earlier, if the amount over which parent has a testamentary general power of appointment is limited by formula to an amount that would not increase parent's taxable estate to more than the federal estate tax exclusion taking into consideration parent's other assets, then a basis adjustment can be obtained for that amount because there is no need for the debt to offset the assets included in parent's estate. The trust should provide that it is for the benefit of the child's descendants, not the child, to avoid the one year "no step up allowed" limitation of section 1014(e).

Might the IRS argue that payment on the note is an indirect return of assets to the child? To the extent the note is not for fair market value that would be a direct return of assets. Suppose the terms of the trust and the sale provided that no assets could be used to pay off the note beyond those required to satisfy the fair market value of the note as determined for federal gift tax purposes. The hoped for result would be that the amount of child's gift would be trapped in the trust and pass other than to a child.

Suppose child "sells" cash to the trust for a note. Section 1014(e) applies by its terms only to "appreciated property" acquired by the decedent by gift within one year prior to the decedent's death. If the cash in the grantor trust is later swapped for child's appreciated property that would not be appreciated property acquired by gift. The cash might have been acquired in part by gift – if the note were not valued at par – but not the appreciated property. Is this extra step valuable in minimizing a challenge?

Does the death of parent terminate the grantor trust status of the trust? If yes, that could cause the sale to be recognized by child as of that moment, thus undoing the benefits of the transaction. But note there is an argument that because the "sale" was to a grantor trust, there never was a debt in the first place; no debt, no gain recognition even when grantor trust status terminates. For a more complete discussion of this position, *See* Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 J. Tax'n 149 (2002). Regardless, it appears clear that a sale to a grantor trust where grantor trust status terminates because the grantor dies is not a taxable event; there the policy appears to be that death cannot, or should not, trigger a taxable transaction. Treas. Reg. §1.671-2(e)(1) provides that a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer – defined as any transfer other than one for fair market value – of property to a trust. Section 678 by its terms confers grantor trust status (or status that is substantially similar to grantor trust status) only in situations involving inter vivos general powers. An inter vivos right to withdraw makes the powerholder the trust's owner under section 678 but not replacing the true grantor if it is a grantor trust with respect to the grantor. What is the effect of parent's testamentary general power of appointment? Treas. Reg. §1.671-2(e)(6) contains two examples that are close but not directly on point:

> Example 4. A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.
>
> Example 8. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

Note that this is the same issue which exists with respect to creating a lifetime QTIP trust that is a grantor trust with respect to the creating spouse. After the beneficiary spouse dies, the property may remain in trust for the benefit of the creating spouse and the couple's descendants becoming, essentially, a credit-shelter trust. However, if the creator spouse remains the grantor of the trust for income tax purposes that will produce a substantial additional transfer tax benefit. Cf. Jonathan G. Blattmachr, Mitchell M. Gans & Diana S.C. Zeydel, "Supercharged Credit Shelter Trust," 21 Probate & Property 52 (Jul/Aug 2007).

B. <u>Income Tax Benefits.</u>

Assets included in a parent's estate for estate tax purposes obtain a new income tax basis under section 1014(b)(9) assuming no exercise of the general power, but not if assets acquired by the parent from a child by gift within one year of the parent's death pass back to the child or the child's spouse (§1014(e)). Suppose that the assets pay into a trust for descendants only but a third party has a power of appointment to add beneficiaries to the trust (which could include the child)?

Depreciable property has special issues. Section 1014(b)(9) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent. Because the UPSTAT will remain a grantor trust as to the younger generation grantor who originally took the depreciation deduction, after the death of the older generation holder of the general power of appointment, then the amount of the basis adjustment might be reduced by the amount of the depreciation deductions allowed to the younger generation grantor prior to the older generation member's death. Treas. Reg. §1.1014-6 states:

> (a) In general.
>
> (1) The basis of property described in section 1014(b)(9) which is acquired from a decedent prior to his death shall be adjusted for depreciation, obsolescence, amortization, and depletion allowed the taxpayer on such property for the period prior to the decedent's death. Thus, in general, the adjusted basis of such property will be its fair market value at the decedent's death, or the applicable alternate valuation date, less the amount allowed (determined with regard to section 1016(a)(2)(B)) to the taxpayer as deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion for the period held by the taxpayer prior to the decedent's death. The deduction allowed for a taxable year in which the decedent dies shall be an amount properly allocable to that part of the year prior to his death. For a discussion of the basis adjustment required by section 1014(b)(9) where property is held in trust, *See* paragraph (c) of this section. [dealing with uniform basis]

The Senate Finance Committee explained its purpose in 1954 as follows:

> Your committee added a specific rule for determining the basis of property transferred before the death of the decedent. So that the donee will not receive a double deduction it is provided

> that his new basis will be the value of the property at the date of the decedent's death . . . less the total of his deductions for depreciation, depletion, and amortization of property he received by gift. This rule will not involve the recomputation of the deductions already taken for the period prior to the decedent's death.

The situation the provision was designed for was where grantor gave property to X but retained an interest. X took deductions, then received a step-up, because of the string provisions, and took the deductions a second time. Arguably, this is different from the "upstream" trust (UPSPAT, that is from younger to older generation) because the decedent received nothing "by gift" but rather by purchase. Even though the purchaser was the grantor's grantor trust, the decedent guaranteed the debt.

C. Assets Returning to the Grantor/Child Other Than Via Note Payment.

Parent having a general power may not transform the parent into the owner/grantor for section 2038 purposes. Section 2038 provides that it applies without regard to when or from what source the decedent acquired such power (but the discussion of Skifter and its progeny earlier in these materials). There appears to be no authority on whether section 2041 breaks the chain. Section 2044(c) does break the chain in the marital deduction context.

D. Limiting Parent's Ability to Divert Assets.

The strategies called for require that parent have a testamentary general power of appointment. A power limited to the appointment of assets to the creditors of a parent's estate will be a general power under section 2041(b)(1). If it is desirable that a parent have additional discretion the parent could be given a power to appoint to descendants, with or without charities, and such additional powers could be conditioned on the consent of child or others because all that is required in order to capture the tax benefits is the limited testamentary general power.

If a child desires to receive an interest in the assets transferred to parent back from parent (e.g., parent transfers the assets into a trust for child and child's descendants that is not available to child's creditors), then giving parent a power that is broader than a power to appoint to the creditors of parent's estate may be desirable. For example, a parent could be given a power to appoint to parent's children and the creditors of parent's estate. Child could ensure that assets were not diverted to a sibling by purchasing from the siblings an assignment of any rights the siblings receive in assets appointed by parent that originated with child (although a generic spendthrift clause could create a problem). The assignment would be independent of parent but would limit the ability of a creditor (or the government) to argue that the child transferred the assets to parent in a manner that did not give parent any true control. The ability to reach such an agreement with minors is limited.

E. Parent's Creditors.

A parent who has or is likely to have creditors will not be a good candidate for these sorts of transactions. Creditors could include health-care providers or Medicaid, tort victims (for example, if parent is still driving), and beneficiaries of legally binding charitable pledges.

In addition, by definition, a parent who is married to someone who is not also child's parent has a potential creditor at death although in limited instances marriage agreements coupled with state law limitations on the rights of a surviving spouse to take property over which a decedent has a testamentary general power of appointment may make these transactions feasible.

The cautionary tale in this area is the Sligh case. Sligh v. First National Bank of Holmes County, 704 So. 2d 1020 (Miss. 1997) is an example of a common law court exposing assets to creditors because it believes that is the fair and right result. The facts involved were that:

> On January 30, 1993, William B. Sligh was involved in an automobile accident with Gene A. Lorance, an uninsured motorist who was operating a vehicle while intoxicated. As a result, Will Sligh suffered a broken spine and resulting paralysis, including loss of the use of both legs, loss of all sexual functions and loss of the ability to control bowel and urinary functions. Lorance was convicted of the felony of driving under the influence and causing bodily injury to another, for which he was sentenced to serve ten years, with six years suspended, in the custody of the Mississippi Department of Corrections.

Lorance had no assets except his interest in two spendthrift trusts created by his mother but was subject to a $5,000,000 default tort judgment as a result of the accident. The court noted:

> The Slighs alleged, in addition to the aforementioned facts, that Lorance's mother, Edith Lorance, had actual knowledge of the following facts: her son was an habitual drunkard who had been unsuccessfully treated for alcoholism; he was mentally deficient and had been previously committed to mental institutions; he had impaired facilities due to his alcoholism and mental disorders; he regularly operated motor vehicles while intoxicated; he was a reckless driver who had been involved in numerous automobile accidents; and he had been arrested and convicted on numerous occasions for driving under the influence. The complaint alleged that despite her actual knowledge of these facts, Mrs. Lorance established the two trusts as part of her intentional plan and design to enable her son to continue to lead his intemperate, debauched, wanton and depraved lifestyle while at the same time shielding his beneficial interest in the trusts from the claims of his involuntary tort creditors. The Slighs alleged that it was a violation of public policy to enforce and give priority to spendthrift trust provisions over involuntary tort judgments against the beneficiary, and they urged the court to recognize and enforce a public policy exception to the spendthrift trust doctrine in favor of involuntary tort creditors by subjecting Lorance's beneficial interests to the payment of their tort judgment in one or more of several equitable ways suggested in their complaint.

The spendthrift doctrine was judicial in Mississippi, created by Leigh v. Harrison, 11 So. 604 (1892) and Calhoun V. Markow, 151 So. 547 (1933). The opinion states:

> Upon examination of the two Mississippi cases, Leigh and Calhoun, one can identify three public policy considerations observed by this Court when enforcing spendthrift trust provisions: (1) the right of donors to dispose of their property as they wish; (2) the public interest in protecting spendthrift individuals from personal pauperism, so that they do not become public burdens; and (3) the responsibility of creditors to make themselves aware of their debtors' spendthrift trust protections. Upon consideration of these public policy concerns in the present context, we find that they do not weigh in favor of enforcing spendthrift trust provisions as against the claims of tort creditors or those found liable for gross negligence.

With respect to the second and third policies, the court found that protection from tort creditors was not the purpose:

> Regarding the responsibility of creditors when entering into transactions with spendthrift trust beneficiaries, Austin W. Scott stated in The Law of Trusts:
>
> In many of the cases in which it has been held that by the terms of the trust the interest of a beneficiary may be put beyond the reach of his creditors, the courts have laid some stress on the fact that the creditors had only themselves to blame for extending credit to a person whose interest under the trust had been put beyond their reach. The courts have said that before extending credit they could have ascertained the extent and character of the debtor's resources. Certainly, the situation of a tort creditor is quite different from that of a contract creditor. A man who is about to be knocked down by an automobile has no opportunity to investigate the credit of the driver of the automobile and has no opportunity to avoid being injured no matter what the resources of the driver may be.
>
> Scott, supra. Likewise, George T. Bogert reasoned in Trusts and Trustees:
>
> It is true that a tort creditor has had no chance to choose his debtor and cannot be said to have assumed the risk of the collectibility of his claim. The argument for the validity of spendthrift trusts based on notice to the business world of the limited interest of the beneficiary does not apply. It may be argued that the beneficiary should not be permitted to circumvent the case and statute law as to liability for wrongs by taking advantage of the spendthrift clause.

> George T. Bogert, Trusts and Trustees S 224 (2d ed. Rev. 1992). As these scholars point out, it is plain to see that one of the main reasons for enforcing spendthrift trust provisions--the responsibility of creditors to be aware of the law and of the substance of such provisions--simply does not apply in the case of tort judgment creditors.
>
> As for the public interest in protecting spendthrift individuals from personal pauperism, we believe that this interest is not as strong in the case of tort judgment creditors, where the inability to collect on their claims may well result in their own personal pauperism. While it is true that most contract creditors do not risk becoming insolvent if they do not collect on a particular claim, such is often not the case with tort judgment creditors, particularly those who have suffered such devastating and expensive injuries as did the Slighs. The public interest against individuals becoming public burdens would not be served by protecting a spendthrift tortfeasor from personal pauperism where such protection would result merely in the pauperism of his victim. If one must choose whom to reduce to personal pauperism in such a case, the spendthrift tortfeasor or the innocent tort judgment creditor, we are inclined to choose the party at fault, especially where that fault rises to the level of gross negligence or intentional conduct.

The court had more difficulty with the right of persons to bequeath property as desired:

> Clearly, the right of donors to place restrictions on the disposition of their property is not absolute, for as discussed above, there are several generally recognized exceptions to the spendthrift trust doctrine. Rather, a donor may dispose of his property as he sees fit so long as such disposition does not violate the law or public policy. We find that it is indeed against public policy to dispose of property in such a way that the beneficiary may enjoy the income from such property without fear that his interest may be attached to satisfy the claims of his gross negligence or intentional torts.
>
> Our tort doctrine has evolved into two types of torts, ordinary torts and intentional torts. Public policy deems it so important to deter the commission of intentional torts or acts of gross negligence, that we allow victims of gross negligence or intentional torts to recover damages above and beyond what is necessary to compensate them for their injuries, i.e., punitive damages. However, the intended deterrent effect would be completely lost upon individuals whose interests are immune from the satisfaction of such claims.

> The Slighs have alleged facts to the effect that Lorance's mother intended that her son should be able to commit acts of gross negligence or intentional torts without fear that his beneficial interests would be attached as a result thereof. However, in cases such as this where the donor has died, such facts may often be difficult, if not impossible, to prove. We hold that plaintiffs need not prove such facts but that such intent shall be presumed where a party has obtained a judgment based upon facts evidencing gross negligence or an intentional tort against the beneficiary of a spendthrift trust. Furthermore, we state the natural corollary that when assessing punitive damages against a tortfeasor found to have committed gross negligence or an intentional tort who is a spendthrift trust beneficiary, the beneficiary's interest should be taken into account as a factor in determining his monetary worth. However, in order to uphold spendthrift trust provisions so much as is reasonably possible, we hold that the beneficiary's interest in a spendthrift trust should not be attached in satisfaction of a claim until all of his other available assets have first been exhausted.

The dissenting justices expressed concern:

> I must respectfully dissent to the limitations placed by the majority on the exempt status of spendthrift trust benefits. The majority acknowledges that Louisiana is the only other State to place such limitations on spendthrift trust benefits for tort creditors, and said limitations were implemented by the Louisiana legislature rather than the courts of said state. This Court is thus, apparently, the first to so limit the exempt status of spendthrift trust benefits. I am aware of the public policy considerations which motivated the majority's decision, but, in my view, the general rule favoring the exempt status of spendthrift trusts benefits is a sound one which is in no need of revision.
>
> Spendthrift trusts provide a means for a parent or other concerned party to provide for the basic needs of a beneficiary, and the largely exempt status of the trust benefits has given comfort and support to countless settlors and beneficiaries. The facts of the present case are tragic, but this Court should, in my view, avoid changing longstanding precedent based on the fact pattern of a particular case. Creditors in this state have at their disposal a number of means of collecting judgments, and I fear that the majority opinion signals the start of a gradual decline of the spendthrift trust in this state. I would affirm the ruling of the trial court, and I must accordingly dissent.

A petition for rehearing was denied. Subsequently Mississippi enacted a statute reversing this result.

The Uniform Act provides rules on the rights of the powerholder's creditors in the appointive property. These rules vary depending on whether the power is a general power created by the powerholder (§501), a general power created by someone other than the powerholder (§502), or a non-general power (§504). There is also a provision (§503) treating a power of withdrawal from a trust as the equivalent of a presently exercisable general power for this purpose; but upon the lapse, release, or waiver of the power of withdrawal, the Uniform Act follows the Uniform Trust Code in creating an exception for property subject to a Crummey or other five and five power.

A general power created by the powerholder will be ineffective to shelter assets from creditors. *See* § 501. First, § 501(b) states the well-settled rule that the creator of a power of appointment cannot use a fraudulent transfer to avoid creditors. If a donor fraudulently transfers appointive property, retaining a power of appointment, the donor/powerholder's creditors and the creditors of the donor/powerholder's estate may reach the appointive property as provided in the law of fraudulent transfers. On the other hand, as § 501(c) states, if there is no fraudulent transfer, and the donor/powerholder has made an irrevocable appointment to a third party of the appointive property, the appointed property is beyond the reach of the donor/powerholder's creditors or the creditors of the donor/powerholder's estate. In other words, an irrevocable and nonfraudulent exercise of the general power by the donor/powerholder in favor of someone other than the powerholder or the powerholder's estate eliminates the ability of the powerholder's creditors or the creditors of the powerholder's estate to reach those assets. Finally, § 501(d) deals with the in-between situation where the donor has retained a general power of appointment but has made neither a fraudulent transfer nor an irrevocable appointment. In such a case, the following rules apply: If the donor retains a presently exercisable general power of appointment, the appointive property is subject to a claim of—and is reachable by—a creditor of the powerholder to the same extent as if the powerholder owned the appointive property. If the donor retains a general power of appointment exercisable at death, the appointive property is subject to a claim of—and is reachable by—a creditor of the donor/powerholder's estate (defined with reference to other law, but including costs of administration, expenses of the funeral and disposal of remains, and statutory allowances to the surviving spouse and children) to the extent the estate is insufficient, subject to the decedent's right to direct the source from which liabilities are paid. This same rule applies under the Uniform Trust Code, § 505(a), where a grantor may revoke a revocable trust. The application of these rules is not affected by the presence of a spendthrift provision or by whether the claim arose before or after the creation of the power of appointment.

These rules apply even if someone else nominally created the power, to the extent the powerholder contributed value to the transfer. The Comment to § 501 sets forth these examples:

> Example 1. D purchases Blackacre from A. Pursuant to D's request, A transfers Blackacre "to D for life, then to such person as D may by will appoint." The rule of subsection (d) applies to D's general testamentary power, though in form A created the power.

> Example 2. A by will transfers Blackacre "to D for life, then to such persons as D may by will appoint." Blackacre is subject to mortgage indebtedness in favor of X in the amount of $10,000. The value of Blackacre is $20,000. D pays the mortgage indebtedness. The rule of subsection (d) applies to half of the value of Blackacre, though in form A's will creates the general power in D.
>
> Example 3. D, an heir of A, contests A's will on the ground of undue influence on A by the principal beneficiary under A's will. The contest is settled by transferring part of A's estate to Trustee in trust. Under the trust, Trustee is directed "to pay the net income to D for life and, on D's death, the principal to such persons as D shall by will appoint." The rule of subsection (d) applies to the transfer in trust, though in form D did not create the general power.

These rules were applied in Phillips v. Moore**,** 690 S.E.3d 620 (Ga. 2010)**.** In 1996, Delmus Phillips created a trust to hold real estate for his benefit and the benefit of his family. Under the trust instrument, Phillips was entitled to receive the net income of the trust during his life. Phillips also had a testamentary power of appointment that allowed him to appoint the trust property to anyone of his choosing, including his own estate or creditors. The trust named specific beneficiaries in the event that Phillips failed to exercise the power, and also contained a spendthrift provision that protected the income and principal of the trust from claims of creditors. Phillips filed for bankruptcy in 2007, and the bankruptcy trustee moved for judgment as to whether the spendthrift provision was enforceable. The court granted the trustee's motion and held that the corpus was property of the bankruptcy estate. On appeal, the court noted the lack of controlling Georgia law and certified to the Georgia Supreme Court "whether a settlor of a trust is a sole beneficiary, such that creditors may reach the corpus of the trust, when the trust instrument gives the settlor no right to the corpus during his lifetime but provides him with a general power to appoint the trust corpus as he sees fit in his will and names specific beneficiaries to receive the corpus of the trust in the event that the settlor does not exercise his power of appointment?" The court answered in the affirmative, holding that an income right plus a general testamentary power of appointment allows creditors to reach even the trust corpus during the settlor's life despite the presence of a spendthrift provision.

A general power created by someone other than the powerholder is dealt with by § 502. With an exception for property subject to Crummey withdrawal rights (§ 502(b)), appointive property subject to a general power of appointment created by a person other than the powerholder is subject to a claim of a creditor of: (1) the powerholder, to the extent the powerholder's property is insufficient, if the power is presently exercisable; and (2) the powerholder's estate, to the extent the estate is insufficient, subject to the right of a decedent to direct the source from which liabilities are paid.

The theory behind section 502 is that a presently exercisable general power of appointment is equivalent to ownership. Further, upon the powerholder's death, property subject to a general power of appointment is subject to creditors' claims against the powerholder's estate (for example, administration, funeral and burial expenses, and statutory allowances to the surviving spouse and children) to the extent the estate is insufficient, subject to the decedent's right to direct the source from which liabilities are paid. In each case, whether the powerholder has or has not purported to exercise the power has no effect on this issue.

The Uniform Act follows the Restatement (Third) of Property § 22.3. However, as noted by Comment c to that Restatement section, this is a new rule and is not the common law nor the rule of previous Restatements. The Comment states:

> Historical note. The common-law rule was that the [powerholder's] creditors could not reach appointive assets covered by an unexercised general power of appointment if the power had been created by a person other than the [powerholder]. The thought was that until the [powerholder] exercised the power, the [powerholder] had not accepted sufficient control over the appointive assets to give the [powerholder] the equivalent of ownership of them. Restatement Second of Property (Donative Transfers), still adhered to the common-law rule, but recognized that statutory law in a number of states had abrogated the common-law rule. . . . The Restatement Second implemented the historical rule in three sections. Section 13.2 provided that "Appointive assets covered by an unexercised general power of appointment, created by a person other than the donee, can be subjected to payment of claims of creditors of the donee, or claims against the donee's estate, but only to the extent provided by statute." Section 13.4 provided that "Appointive assets covered by an exercised general power to appoint by will, created by a person other than the donee, can be subjected to the payment of claims against the donee's estate." Section 13.5 provided that "Appointive assets covered by an exercised general power to appoint by deed, created by a person other than the donee, can be subjected to the payment of the claims of creditors of the donee to whatever extent they could have been thus subjected, under the rules relating to fraudulent conveyances, if the appointive assets had been owned by the donee and transferred to the appointee." The Restatement Third of Trusts has now diverged from the common-law rule. *See* Restatement Third, Trusts § 56, Comments b and c. The Restatement Third of Trusts represents the current position of the Institute, and is the rule adopted in this section . ...

The majority view at common law is that the powerholder of a power, conferred on the powerholder by another, is treated as the beneficial owner of the appointive property for purposes of creditors' rights only if (1) the power is general *and* (2) the powerholder exercises the power. No distinction is made between a testamentary and a presently exercisable power. Creditors of a powerholder of a *non-general* power, on the other hand, cannot reach the appointive assets even if the power was effectively exercised. The theory is that the donor who creates a non-general power did not intend to benefit the powerholder.

Explaining the distinction between the exercise and non-exercise of a general power for purposes of creditor access, Univ. Nat'l Bank v. Rhoadarmer, 827 P.2d 561 (Colo. App. 1991) noted:

> When a donor gives to another the power of appointment over property, the [powerholder]... does not thereby become the owner of the property. Rather, the appointee of the power [meaning, the powerholder], in its exercise, acts as a "mere conduit or agent for the donor." The [powerholder], having received from the owner of the property instructions as to how the power may be utilized, possesses nothing but the authority to do an act which the owner might lawfully perform.

Colorado preserved this rule when it adopted the Uniform Act.

When the powerholder of a general power exercises the power by will, the view that the appointed property is treated as if it were owned by the powerholder means that the creditors of the powerholder's estate can reach the appointed property for the payment of their claims. *See,* e.g., Clapp v. Ingraham, 126 Mass. 200 (1879). The rule prevails even if this is contrary to the expressed wishes of the donor of the power. *See,* e.g., State Street Trust Co. v. Kissel, 19 N.E.2d 25 (Mass. 1939).

The exercise of the power by will does not confer actual beneficial ownership of the appointive assets on the powerholder for all purposes. The assets do not ordinarily become part of the powerholder's probate estate. Thus, in terms of priority, the powerholder's own estate assets are ordinarily used first to pay estate debts, so that the appointive assets are used only to the extent the powerholder's probate estate is insufficient.

Under the majority view at common law, the powerholder's creditors can reach the appointive assets only to the extent the powerholder's exercise was an *effective* exercise. A few states, however, follow the view that even an ineffective exercise entitles the powerholder's creditors to reach the appointive assets. *See,* e.g., Estate of Breault, 211 N.E.2d 424 (Ill. App. Ct. 1965). Moreover, even in states adhering to the majority view, an ineffective exercise can sometimes "capture" the appointive assets for the powerholder's estate, in which case the appointive assets become part of the powerholder's probate estate for all purposes, including creditors' rights.

When the powerholder of a general power makes an inter vivos appointment, treating the appointed assets as if they were owned by the powerholder does not automatically mean that the powerholder's creditors can subject the appointed assets to the payment of their claims. If the appointment is in favor of a *creditor*, the powerholder's other, unsatisfied creditors can reach the appointed assets only by having the appointment avoided as a "preference" in bankruptcy proceedings. Apart from bankruptcy, the powerholder can choose to pay one creditor rather than another with his or her owned assets, and the same is true with respect to appointive assets. If the appointment is in favor of a *volunteer* (i.e., the appointment is gratuitous), the powerholder's creditors can reach the appointed assets only if the transfer is the equivalent of a fraudulent transfer under applicable state law.

In a minority of jurisdictions, the powerholder of a general power, conferred on him or her by another, is *not* treated as the owner of the appointive property even if the power is exercised. *See*, e.g., St. Matthews Bank v. DeCharette, 83 S.W.2d 471 (Ky. 1935). Of course, if the powerholder exercises the power in favor of himself or herself or his or her estate, the appointed property becomes owned in the technical sense, and creditors even in states adhering to the minority view would be able to subject the assets to the payment of their claims to the same extent as other property owned beneficially by the powerholder. A minority of states has enacted legislation that affects the rights of the powerholder's creditors. The legislation is not uniform. Some of the legislation expands the rights of the powerholder's creditors and some contracts them. The following is a sampling of the legislation.

> *Michigan* legislation expands the rights of the creditors of the powerholder of an unexercised general power. During the powerholder's lifetime, the powerholder's creditors can subject the appointive property to the payment of their claims if the power is presently exercisable. (If the powerholder has actually made an inter vivos exercise of the power, the rules explained above with respect to inter vivos exercises presumably would be applied.) At the powerholder's death, the powerholder's creditors can subject the appointive property to the payment of their claims. In both instances, however, the appointive property is available only to the extent that the powerholder's owned property is insufficient to meet the debts. *See* Mich. Comp. Laws §556.123.
>
> *New York* legislation expands the rights of the powerholder's creditors in some particulars but restricts them in others. The legislation adopts the same rules as the Michigan legislation, but limits their application to general powers presently exercisable. As to general testamentary powers, the powerholder's estate creditors can subject the appointive property to the payment of their claims only if the powerholder, as donor, reserved the power in himself or herself; as to general testamentary powers conferred on the powerholder by another, the powerholder's estate creditors cannot reach the appointive property even when the powerholder's will exercises the power. *See* N.Y. Est. Powers & Trusts Law §§10-7.1 et seq.

Whether a state follows the common law rule or the new Restatement rule with respect to the rights creditors have to property subject to an unexercised general power of appointment will be relevant when considering the wisdom of giving a trust beneficiary a general power for tax purposes, typically to attract new basis. If the beneficiary has a reasonable possibility of having substantial creditors at death, the risk that the trust property, which likely had no previous exposure to creditors, may be exposed.

Suppose the powerholder of a non-presently exercisable general power exercises the power to appoint the property other than to the powerholder's or the powerholder's estate's creditors. The rights of those creditors are cut-off under this section but they may still have rights under the state's fraudulent transfer law. If the exercise is to pay off one or some creditors at the expense of others there is no state law right of redress for the unpaid creditors although there may be remedies available under federal bankruptcy law (a discussion of which is beyond the scope of these materials).

Section 502(b) provides that a power of appointment created by a person other than the powerholder that is subject to an ascertainable standard relating to an individual's health, education, support, or maintenance within the meaning of section 2041(b)(1)(A) or 2514(c)(1) of the Code will be treated automatically as a non-general power.

Crummey withdrawal rights are dealt with in § 503 which provides that a current right to withdraw assets from a trust is a presently exercisable general power of appointment. However, upon the lapse, release, or waiver of such power, the power will be treated as a presently exercisable general power only to the extent that it exceeds the annual exclusion amount.

Property subject to the exercise of a non-general power of appointment is not subject to the claims of the powerholder's creditors, per § 504 of the Uniform Act, with two exceptions: If the taker in default of appointment is the powerholder or the powerholder's estate then the power is reclassified as a general power and the rights of creditors change accordingly (§ 504(c)). Further, property subject to a non-general power is subject to the claim of a creditor of the powerholder or the powerholder's estate to the extent that the powerholder owned the property and transferred it in a fraudulent conveyance, reserving the non-general power. This is really an application of the fraudulent conveyance statutes that cause the property to be subject to the creditors, and the rule in the Uniform Act is merely to ensure that the presence of a non-general power does not affect that rule.

The special case of elective share rights of a powerholder's surviving spouse is not dealt with by the Uniform Act because elective share rights are anything but uniform. Section 23 of the Restatement (Third) of Property sets forth what it believes would be good policy, namely that the powerholder is treated as owning property subject to a presently exercisable general power of appointment exercisable by the powerholder immediately before death and property subject to a general testamentary power of appointment exercisable by the powerholder if the powerholder was also the creator of the power. Essentially this would treat the surviving spouse as being similar to any other creditor. The Uniform Probate Code implements this policy in UPC sec. 2-205(1)(A) and (2)(A). Numerous states have adopted some version of this section in their elective share statutes. *See*, e.g., Fla. Stat. § 732.2035 and Ore. Rev. Stat. § 114.665.

F. <u>Other Issues.</u>

Parent should also be a beneficiary of the UPSPAT. If a person has a Crummey withdrawal right but is not a significant trust beneficiary, the right to withdraw is said to be naked. Although a naked general power of appointment is a general power of appointment (e.g., TAM 200907025), in <u>Cristofani v. Comm'r</u>, 97 T.C. 74 (1991), *acq. in result only* 1992-1 C.B. 1, the IRS argued that a naked Crummey power was illusory. *See* also <u>Estate of Kohlsaat v. Comm'r</u>, T.C. Memo. 1997-212.

In principle, a powerholder need not know of the power. However, if the power is given in trust the duties of the trustee should be considered. Section 103(3) of the Uniform Trust Code provides that a person with a general power is a beneficiary of the trust; however, unless the powerholder is also a discretionary beneficiary, the powerholder will not be a qualified beneficiary. Section 813 of the UTC requires the trustee to keep qualified beneficiaries reasonably informed about the administration of the trust and material facts required to protect their interests. Presumably, knowing about a general power of appointment would be in that category. The trust instrument may alter or waive the trustee's duty to inform a powerholder, and the notice provisions of the UTC have been modified in almost every enacting state. Under common law, powerholders were generally not beneficiaries. The knowledge argument is unlikely to be successful for the IRS; courts have rejected the requirement of knowledge for Crummey powers, a case in which no notice was given, and in Cristofani, supra, and more recently in Estate of Turner v. Comm'r, T.C. Memo. 2011-209.

IV. Other Power of Appointment Matters

A. Definition of "person" in the Uniform Act.

The standard definition of "person" in uniform acts is used in the Uniform Act, in § 102(12):

> "Person" means an individual, estate, trust, business or nonprofit entity, public corporation, government or governmental subdivision, agency, or instrumentality, or other legal entity.

This definition matters because powerholders are persons, appointees are persons, and donors—those who create powers—are persons. In short, in the Uniform Act one does not have to be an individual to create a power, have a power, exercise a power, or be the beneficiary of an exercise of a power. Note that the Uniform Trust Code contains a similar definition of "person" and allows trusts to be created by persons.

Consider a trust that gives a limited liability company a power of appointment. The ownership of the LLC could be transferred, thus changing who could control the exercise of the power. Undoubtedly for federal tax purposes the LLC would be looked through and the power treated as held by the owners of the LLC. Consider also a trust that allowed a powerholder to appoint assets to a particular LLC. Because the ownership of the LLC could change, the beneficiaries of the power could change as well, and the exercise of the power could be bought and sold. Rights of withdrawal are presently exercisable general powers of appointment; might there be circumstances where those powers would be better held by an LLC than by individuals?

To date, the only regular use of this expanded definition has been outside the area of powers of appointment. The Uniform Trust Code allows the settlor of a charitable trust to enforce its terms. If a charitably minded individual transfers assets to an LLC and the LLC creates the charitable trust, the LLC is the settlor of the trust for state law purposes, and in a UTC state that has not altered the uniform provisions the LLC may enforce the charitable trust. The LLC need not terminate when the individual who originally created it dies. We can expect additional uses to develop as the Uniform Act becomes widespread.

B. Power to Grant or Modify a Power.

Give someone - - trustee, advisory committee, or trust protector - - the discretion to grant a general power of appointment or to expand a special power of appointment so that it becomes general. The power could be granted shortly before death if the step up in basis is desirable given the tax rates in effect at that time (considering, of course, that when a potential power holder is "shortly before" death may not always be easy to determine). Should the person with the power to grant or expand the power be a fiduciary? Should protection be given for a decision to grant or not to grant the power of appointment? Should the general power be able to be rescinded or modified by the person granting the power?

Where the circumstances are clearly defined, a formula grant of a general power may be easier, and more successful, that a broadly applicable formula. Again, the general power may lapse and still cause inclusion depending on the trust terms and whether the powerholder is a beneficiary.

HOW TO MODIFY OR TERMINATE A TRUST

I. Generally

The commonly understood definition of "irrevocable" is: unchangeable, unalterable, immutable, cast in stone, not able to be revoked. *See* Merriam Webster's Collegiate Dictionary, Eleventh Edition (2003).

During the past couple of decades, however, the term "irrevocable," as used in estate planning, has taken on a new, counter-intuitive meaning. A trust that is said to be irrevocable is, in truth, often nothing of the sort. Numerous legal mechanisms have evolved to facilitate reformation, modification, rescission, termination and decanting of irrevocable trusts. Of particular note are the following:

Thirty-five jurisdictions - Alabama, Arizona, Arkansas, Colorado, Connecticut, District of Columbia, Florida, Illinois, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin and Wyoming - have enacted the Uniform Trust Code ("UTC") with various state-specific modifications.

UTC § 111 allows interested persons to enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust so long as a material purpose of the trust is not thereby violated. Presumably, to invoke UTC § 111, there must be a matter that requires resolution, but that would appear to be an easily surmountable challenge.

UTC § 411(a) authorizes the settlor and all beneficiaries to modify or terminate a noncharitable irrevocable trust, even if the modification or termination is inconsistent with a material purpose of the trust. An alternative version of UTC § 411(a) requires the court to approve such a modification or termination where the court finds that the settlor and all beneficiaries have consented to it.

UTC § 411(b) provides that the court may order a modification or termination of a noncharitable irrevocable trust if all beneficiaries consent to the modification or termination and the court concludes that, in the case of modification, such action is not inconsistent with a material purpose of the trust or, in the case of termination, continuance of the trust is not necessary to achieve any material purpose of the trust. Material purposes are not readily to be inferred. RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. d. This principle is referenced favorably in the Comment on UTC § 411 provided by The National Conference of Commissioners on Uniform State Laws.

Under UTC § 412(a), the court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust.

UTC § 415 allows the court to reform the terms of a trust, even if unambiguous, to conform the terms to the settlor's intention if it is proved by clear and convincing evidence what the settlor's intention was and that the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement.

UTC § 416 states that, to achieve the settlor's tax objectives, the court may modify the terms of a trust in a manner that is not contrary to the settlor's probable intention.

Twenty-four states - Alaska, Arizona, Delaware, Florida, Illinois, Indiana, Kentucky, Michigan, Minnesota, Missouri, Nevada, New Hampshire, New Mexico, New York, North Carolina, Ohio, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Virginia, Wisconsin and Wyoming - have enacted "decanting" statutes, which, to various extents, allow a Trustee having a discretionary distribution power to exercise that power by distributing to a new trust rather than outright to the beneficiary to or for whom the Trustee is empowered to distribute. Depending on the state, the new trust, as compared to the trust out of which the distribution was made, may have different standards for distribution, may permit or direct distributions at a different time or times, may create a new power of appointment and may include different beneficiaries.

II. <u>UTC Methods</u>

When the settlor of a noncharitable irrevocable trust is alive and able and willing to consent, and all beneficiaries agree, UTC § 411(a) allows the trust to be terminated or the trust instrument to be modified without court approval, even if the modified trust terms are, or the termination is, inconsistent with a material purpose of the trust. A UTC § 411(a) modification or termination is among the most flexible trust modification or termination techniques as there are relatively few limits on the potential changes to or termination of the trust if the settlor and all beneficiaries agree. Virtual representation under UTC §§ 303 and/or 304 may be used to bind minor, unborn, unknown, unascertained current and potential future beneficiaries. The consent of the Trustee is not required, but it may be wise to consider seeking the Trustee's consent if the Trustee has a right to commence a proceeding to disapprove the modification or termination under the applicable state's version of UTC § 410(b).

Under UTC § 411(b), a noncharitable irrevocable trust may be terminated, or the governing instrument modified, even if the settlor is deceased or is unable or unwilling to consent, but only under the following conditions: First, court approval is required. Second, the termination or modification may not violate a material purpose of the trust.

UTC § 411(e) gives the proponents of a modification or termination, and the court, a little latitude to enable a UTC § 411(a) or § 411(b) modification or termination to proceed even if not all beneficiaries are on board. The court can approve such a modification or termination if it is satisfied that, had all beneficiaries consented, the modification or termination could properly have been implemented and the interests of any nonconsenting beneficiary will be protected.

Where a Trustee is involved in a judicial modification of a trust agreement, typically the finality and authority of a judicial decision will have the result of protecting the Trustee from liability regarding any claims challenging the validity of the modification. However, where the Trustee initiates or otherwise actively advocates in a modification proceeding, the Trustee may nevertheless be exposed to suits based on the propriety or effect of the modification (if, for example, the modification had adverse tax consequences on the trust itself, the settlor or a beneficiary). A prudent Trustee will be alert to these potential areas of liability, which can be foreclosed with informed consents from interested parties or those with the ability to represent and bind one or more interested parties as described in UTC §§ 301-305. Douglas J. Stanley and Jarriot L. Rook, "Issues to Consider in Nonjudicial Settlement of Fiduciary Disputes," St. Louis B. J., Spring 2016 [hereafter, Rook and Stanley].

In a nonjudicial trust modification (a "nonjudicial settlement agreement") under UTC § 111, the Trustee will want to ensure that all of the elements of UTC § 111 are met. As these elements are not set forth as "safe harbors" but, rather, are fact-sensitive, a Trustee participating in a nonjudicial settlement agreement might consider seeking judicial approval of the nonjudicial settlement agreement (as contemplated by UTC § 111(e)), especially if the Trustee perceives a potential conflict of interest between a representative and the party represented or if the Trustee is concerned that the representative will not adequately protect the interests of the party represented.

The advisability of obtaining consents from all interested parties applies generally to all trust modifications, whether judicial, nonjudicial or pursuant to UTC § 111 or a similar statute or the common law. These consents should provide some extra degree of protection for the Trustee participating in a nonjudicial modification, even if the other requirements of a nonjudicial modification are ultimately determined to be defective in some way, based on general trust principles (and UTC § 1009), which generally provide that a Trustee is not liable to a beneficiary for a breach of trust where the beneficiary gave informed consent to the action constituting the breach. RESTATEMENT (SECOND) OF TRUSTS § 216; 4 Austin Wakeman Scott, William Franklin Fratcher & Mark L. Ascher, SCOTT AND ASCHER ON TRUSTS, Section 24.21 (5th ed. 2008). Because a consent is invalid if the beneficiary did not know all the relevant, material facts, *see, e.g.*, UTC § 1009, the Trustee may want to attach to the consent documents copies of all the documents related to the trust modification. Todd A. Flubacher, "Controlling From the Grave, Is Flexibility a Good Thing?" AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, 2015 Annual Meeting.

The extent of a Trustee's liability with respect to his, her or its participation in a trust modification may be affected if the trust to be modified is a "directed trust," *i.e.*, a trust the governing instrument of which provides that a third party (the "director") will direct one or more of a Trustee's responsibilities. The director has the power to direct the Trustee as to the matter under the third party's control, and usually the Trustee has no discretion over that particular area of administration. Therefore, if the trust to be modified is a directed trust, and the question of whether or not to engage in a trust modification is one that falls within the authority of the director, the Trustee presumably would be protected from liability for following the director's instructions with regard to the modification. However, it is important to remember that, although the concept of a directed trust is not new, states have only recently begun setting the statutory framework for the powers and duties of directed Trustees. Further, Trustee liability in the context of directed trusts is based in part on the extent to which a directed Trustee may or must follow directions from a third party. Liability may also arise from the inaction of a directed Trustee if that Trustee is under an obligation to monitor the director's actions. Given the relative novelty of state statutes specifically dealing with directed trusts, this area of law remains relatively untested in the courts.

III. Another Approach: Decanting

Another technique available to settle disputes privately between or among beneficiaries, or between beneficiaries and Trustees, is "decanting." In general, decanting is a transaction whereby a Trustee exercises discretionary distribution authority set forth in an existing trust instrument by distributing not directly to the target beneficiary but, rather, to a new trust for the benefit of the target beneficiary and perhaps one or more others. An example of how decanting may be used to settle disputes is where a conflict has arisen from ambiguous dispositive provisions in a trust instrument. Once the parties have agreed among themselves how to interpret the ambiguous trust language, the Trustee can decant into a new trust whose governing instrument contains the newly agreed-upon language and avoid court involvement. It may be difficult or impossible to achieve this same result using any other nonjudicial modification option. Note, however, decanting may be used only if the original trust instrument does not contain language prohibiting its use. Rook and Stanley, s*upra*.

Significant differences exist among the laws of the twenty-four states that have enacted decanting statutes. Some decanting statutes specify that the Trustee is under no duty to complete a decanting. *See,* e.g., O.R.C. § 5808.18(J); Ind. Code Ann. § 30-4-3-36(g). Some statutes specify that a decanting may be completed whether or not there is a current need to distribute principal or income to a beneficiary. *See,* e.g., N.C. Gen. Stat. § 36C-8-816.1(b). Such a statutory provision anticipates an argument by a disgruntled beneficiary that a Trustee breached the Trustee's fiduciary duty by completing the decanting when, under the terms of the Trustee's discretionary distribution authority, there was no occasion to make an outright distribution of trust income or principal. Rashad Wareh & Eric Dorsch, "Decanting: A Statutory Cornucopia," TRUSTS & ESTATES, March 2012, at 22.

The Trustee should seek to ensure that the risks of fiduciary liability arising from the decanting are minimized. The issue of Trustee liability will be especially important if the second trust changes the interests of the current or remainder beneficiaries. For example, the Trustee of the first trust may have the ability to transfer all the property of the first trust to the second trust and exclude certain beneficiaries of the first trust from being beneficiaries of the second trust. *See, e.g.*, NY EP&TL § 10-6.6(b).

Although decanting statutes do not require beneficiary consent, a decanting Trustee and his, her or its attorney nevertheless should attempt to secure consents from as many beneficiaries as possible, including current and remainder beneficiaries, whether contingent or vested.

Of course, there is a strong argument that, since decanting is fundamentally a discretionary principal distribution, the Trustee should be prepared to proceed without consents as with any discretionary principal distribution. In that situation, the Trustee must ensure that the decanting is in strict accordance with the applicable decanting statute. *See,* e.g., In re Petition of Johnson, 2015 N.Y. Misc. LEXIS 51 (N.Y. Surr. 2015) (upon complaint by beneficiary, decanting invalidated by court because the decanting resulted in the addition of beneficiaries under the new trust in violation of the New York decanting statute).

The second trust may include new protections for the Trustee, such as an exculpatory clause that covers actions or inactions during the administration of the first trust, and a provision authorizing decanting and the specific procedures to be followed. *See* Farhad Aghdami & Jeffrey D. Chadwick, "Decanting Comes of Age," AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, 2013 Annual Meeting.

The IRS issued Notice 2011-101, 2011-52 I.R.B. 932, requesting comments regarding the income, gift, estate and GST tax consequences arising from a decanting that changes a beneficiary's interest. The IRS stated that, while these issues are under study, it will not issue private letter rulings regarding any decanting that results in a change in beneficial interests. Rev. Proc. 2011-3, 2011-1 I.R.B. 111. This notice should weigh heavily in a Trustee's decision regarding whether to decant. The IRS has not, however, listed decanting regulations on its latest priority guidance plan. *See* Joint Treasury, Internal Revenue Service 2017-2018 Priority Guidance Plan (Oct. 20, 2017).

OTHER 2021 PLANNING THOUGHTS

I. The Problem.

We have too many variables. Income tax rates are likely to increase but we don't know the break points ($400,000 and above? what does that really mean?) or on what kinds of income. For instance, will there be further changes in carried interests or will there be general increase in capital gains rates? Will rates be tied together – I earn a million dollars and have $10,000 worth of gain; will I be taxed as a million dollar earner or as a small-time recipient of capital gains?

Some have seemingly given up on the income tax system and want to impose a new kind of tax during lifetime, a wealth tax. That has the benefit of creating "instant" revenue, but, of course, has complexities including valuation issues and to some degree "flight" issues. The benefits of a new tax are unclear as compared with the revenue potential of graduated, increased income tax rates.

Death is no simpler. Reducing the applicable exclusion amount would seem likely. Perhaps increasing the rate, either as a flat rate or restoring a graduated rate. Although it is unclear that the estate tax and the step-up in basis were tied together originally, in the minds of many they make a natural complement: at death you receive new basis but you pay estate tax. When $60,000 was exempt, or $600,000, or perhaps even $1,000,000 the two could be thought of as complementary policies but the connection is attenuated with an $11,700,000 exempt.

We remember that in 2001 (the Economic Growth and Tax Relief Reconciliation Act of 2001) the sunset of the estate tax was accompanied by carryover basis, with additional basis that could be sprinkled, like pixie dust, by the personal representative -- $1.3 million for all taxpayers and $3 million for transfers to spouses. Without some sort of sprinkled basis the elimination of a step-up in basis means a tax increase for taxpayers who are currently sheltered by an $11.7 million applicable exclusion. Perhaps taxpayers at the higher end of the $0 - $11.7 million range do not concern those in Congress and the White House, but those in the lower range very well might!

In 2010 we unexpectedly had a natural experiment. Taxpayers could elect no estate tax and no change in basis, or could opt into the estate tax system and receive new basis. Is that a way forward?

There are many proponents of taxing capital gains when assets are transferred whether by gift or at death. This is an income tax so we might expect that the taxable transfer occurs when grantor trust status terminates. To that end, it is important to position grantor trusts so that grantor status may be terminated quickly in the event that becomes important.

II. <u>Don't Forget Other Potential Changes To the Transfer Tax System</u>.

Another way to raise revenue is to enforce the taxes currently on the books. In the estate tax area various "loopholes" continue to draw attention.

One of those is valuation discounts. Since 1993 and Rev. Rul. 93-12 we have seen the IRS and courts largely fail in their various efforts to control valuation discounts. Efforts were considered by Treasury under Presidents Bush (43) and Obama, the IRS has tried various litigation strategies, and most recently the Tax Court has indicated it might try the broad application of section 2036(a)(2) and section 2043 to reduce the benefits of discounts at least indirectly. The nub of the difficulty is the application of the willing buyer-willing seller test which values transfers to third parties and transfers within families similarly; a political difficulty with changing that approach is that by definition it will be anti-family which is often a flash-point politically.

Grantor trusts are another area of concern. Not only sales to grantor trusts but also GRATs "work" only because of the grantor trust rules and the interpretation given in Rev. Rul. 85-13. Further, the IRS position that the payment of income tax by a grantor on the income of a grantor trust is not a gift to the grantor trust, even if the grantor acting alone could turn off grantor trust status, as set forth in Rev. Rul. 2004-64, allows for tax-free compounding within grantor trusts. The annual Treasury work-plans for many years have stated that grantor trust issues are the subject of consideration, especially the question of what is the basis of assets in a grantor trust when the grantor dies.

III. <u>Strategies</u>.

Ideally we would have a client transfer assets in such a manner that if the client wanted, at a future date, to have made a gift the client would have made a gift, but if the client wanted, at that future time, not to have made a gift the client wouldn't have made one. Further, we would want the gift and income from the gift to be allocable within a range of beneficiaries, typically family members but not always, with the potential, at least, for the client grantor to obtain benefits if needed. Such a result is not easy to obtain.

The backbone of flexible estate planning is a grantor trust for the benefit of the grantor's beneficiaries. Partial flexibility can be obtained through trustee distributions which must be coordinated with the standards set forth in the trust and the nature of those standards affects whether the assets of the trust are included in the trustee's or a beneficiary's estate. Further flexibility can be obtained via powers of appointment. The degree to which the grantor may be a current or future beneficiary is dependent in significant part on the ability of the grantor's creditors to reach the trust assets under applicable state law. However, in all events, the IRS can assert various theories to try to include assets in a grantor's estate where, in effect, the grantor has made a gift and then benefitted from them (or controlled the assets). Regardless, gifts to such a trust can be made complete with all that entails including, for instance, no future basis change at the grantor's death. A return of assets from the trust to the grantor may generate a basis change but at the cost of using up transfer tax exemption which is likely undesirable.

To enable the return of assets to the grantor with a wash-out of the gift other measures must be taken. One could be to enable the trustee of the trust to disclaim and for the disclaimed assets to return to the grantor. A trustee may disclaim if the trust so provides, although consideration should be given to possible beneficiary complaints. A disclaimer allows a transaction to be undone for nine months provided that the property given does not provide benefits in the meantime – in other words, no income distributions or use of the assets.

A life-time QTIP may allow a longer postponement depending on the calendar. A grantor funds a trust that qualifies for QTIP and either makes a taxable gift or makes a QTIP election which treats the gift as being made to the spouse only. For example, a QTIP election for a 2021 trust would not need to be made until October 15, 2022.

Other strategies have been discussed. For example, a Grantor Retained Income Trust would produce a taxable gift but would pay income back to the grantor. If the term were set such that the grantor died during the term, the gift would wash out under section 2001(b) and the assets of the GRIT would be included in the grantor's estate. Potentially such a transaction could be dealt with by some anti-abuse rule conjured up by Treasury but regardless a GRIT is not particularly flexible. If the grantor doesn't want the assets back in the estate options are limited. Similarly, a longish term GRAT could be used to similar effect. Certain "defective" transactions under section 2701 which produce gifts automatically regardless of the economics of the transaction might also be possible but because the tax consequences and the economic consequences diverge an anti-abuse rule might find an easy target.

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